

ECONOMIC CRISIS: THE GLOBAL IMPACT OF A GREEK DEFAULT

HEARING

BEFORE THE

SUBCOMMITTEE ON NATIONAL SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE SYSTEMIC RISKS GREECE COULD POSE TO THE REST
OF THE EUROZONE AND THE BROADER INTERNATIONAL ECONOMY

JUNE 25, 2015

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.fdsys.gov/>

U.S. GOVERNMENT PUBLISHING OFFICE

97-475 PDF

WASHINGTON : 2015

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

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THURSDAY, JUNE 25, 2015

U.S. SENATE, SUBCOMMITTEE ON NATIONAL SECURITY
AND INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee convened at 1:36 p.m., in room 538, Dirksen Senate Office Building, Hon. Mark Kirk, Chairman of the Subcommittee, presiding.

Chairman KIRK. We will begin. I will recognize my Ranking Member, Ms. Heitkamp, for an opening statement.

STATEMENT OF SENATOR HEIDI HEITKAMP

Senator HEITKAMP. Thank you. I want to thank you, Chairman, for arranging this hearing on Greece's financial situation, and thank you to all of our witnesses for offering your expertise in this area. Your perspectives and opinions are incredibly important as Congress monitors the global financial system and I look forward to hearing those opinions. Barring consideration of reauthorization of the Export-Import Bank, which both me and the Chairman are leading on, I cannot think of a more timely topic.

The United States and Greece are a tale of two economies. In 2007, our country experienced a housing crisis driven by low interest rates, poor underwriting, and outright fraud, and then a financial crisis driven by lax oversight and regulation and a complex financial system we did not understand. The Nation's real GDP fell by 2.6 percent in 2009, the largest decline in six decades. Our unemployment rate rose to 10 percent in October of 2009. And, fortunately, we have a mature economic recovery, in part because of Federal efforts to buoy the economy and actions taken by the Federal Reserve.

Five years after the onset of the global financial crisis, however, Greece's economy remains in turmoil. The country has experienced what is essentially a second depression. Since 2007, the Greek economy has contracted by nearly 25 percent. Unemployment has tripled, to nearly 25 percent. Youth unemployment is over 50 percent. And public debt has risen to 173 percent of GDP.

The causes of Greece's precarious situation are multiple and complex and I look forward to our witnesses shedding some light on how we got here and where we go from here.

Much has changed since Greece negotiated its second financial assistance package. Ireland and Portugal, countries who also turn to the Eurozone and the IMF for financial assistance, successfully

concluded their programs and have returned to capital markets and are in the process of repaying the IMF early. The economies of the Eurozone, barring Greece, have strengthened, and importantly for the United States, private financial institutions have substantially reduced their exposure to Greece and policy measures adopted over the last several years have lessened the chance that a Greek default or an exit from the Eurozone results in another global financial crisis.

As Greece and its creditors negotiate a third and, hopefully, final financial assistance package, several points appear clear to me. First, we must balance fiscal responsibility with economic development. The Greek people have suffered an unimaginable hardship. The economy will remain in shambles for years, and unfortunately, likely decades to come, because of poor decisions and potentially because of severe austerity policies.

Second, we must continue to develop and implement a sound regulatory framework for viable global financial systems through international cooperation. I am hopeful that Greece and its creditors will reach a pragmatic compromise to prevent more hardship for the Greek people and calm the situation in Europe.

Thank you, Mr. Chairman, for bringing this hearing together on this very important topic and I look forward to hearing from our witnesses.

OPENING STATEMENT OF CHAIRMAN MARK KIRK

Chairman KIRK. I will recognize myself for a quick opening statement before introducing the witnesses.

I will say that I have been wanting to call this hearing since I became the Chairman of the Subcommittee. The Greek situation serves as a warning for local and State governments around America that are now running out of money.

Many of us can recall the names of these Governments that are struggling with some of these issues. The American governments that we are worried about in the credit situation include Detroit, Michigan, and Stockton, California, Harrisburg, Pennsylvania, plus my own home State of Illinois, including our Chicago Public School System.

As policymakers, Senators must make sure that these credit crises are reduced. I will note that issues arising from German reparations after World War I did play a role in sparking the Great Depression and ensuing Second World War. Luckily, the greatest generation did found a financial firefighting team that included the IMF and World Bank and other Bretton Woods institutions.

This hearing is intended to calm fears by outlining what implications there are for America's economy in the face of the Greek credit crisis. I look forward to hearing from our distinguished witnesses, all doctors, I would note, to tell us what the effect could be on the U.S. economy.

Let me start with some introductions. I would like to introduce some of our witnesses. We are very happy to have Dr. Desmond Lachman, the Senior Resident Fellow for the American Enterprise Institute for Public Policy.

Dr. Carmen Reinhart is the coauthor of this best selling *New York Times* book, "This Time Is Different". Carmen is also the

Minos A. Zombanakis Professor of International Financial Systems at the John F. Kennedy School of Government at Harvard University.

We also have with us Dr. Matthew Slaughter, the incoming Dean of the Dartmouth Business School, otherwise known as the Tuck School of Business at Dartmouth College.

And, we also have Dr. Jacob Kirkegaard, a Senior Fellow at the Peterson Institute for International Economics.

Let us start with Desmond. Why do you not deliver your testimony.

**STATEMENT OF DESMOND LACHMAN, RESIDENT FELLOW,
AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY
RESEARCH**

Mr. LACHMAN. Thank you very much, Senator Kirk and Ranking Member Senator Heitkamp, for giving me the honor to testify before you this afternoon.

I would like to make five basic points. First, Greece is very likely to exit and default within the next 12 months. Now, while an agreement between Greece and its official creditors still appears possible that could release the funds that Greece needs to avoid defaulting to the IMF next week, it is highly questionable how long such an agreement will last.

An essential component of such an agreement would likely appear to be yet more of the same failed policies that Greece has pursued under IMF tutelage of the past 5 years. Namely, it would involve substantial fiscal policy tightening within a Euro straight-jacket that relies almost exclusively on tax increases to achieve its budget objectives. Judging by the dismal results of the past, one would think that such an amount of budget tightening in a Euro straightjacket that does not allow currency depreciation is almost certain to deepen Greece's economic depression. That, in turn, risks spreading the Syriza party and throwing the country into a new period of political turmoil that will, in the end, force Greece to exit the Euro.

The second point I would make is that today, fortunately, Europe is in a very much better position to deal with the immediate fallout from a Greek event than it was in 2012. Europe now has in place a European stability mechanism with 500 billion Euros that can provide adequate financing to any Eurozone member that might come under market pressure. More important yet, the European Central Bank now has in place an outright monetary transaction facility that should allow it to do whatever it takes to maintain market stability in the event of a Greek exit. This should prove sufficient to reinvent Greece in the very short run.

The third point I would make is that while European policy-makers appear in a good position to deal with the immediate fallout from a Greek event, they do not appear to be in a good position to deal with the longer-run damage that a Greek exit might cause to the Euro project. A Greek exit would signal very clearly to markets that Euro membership was no longer irrevocable. In addition, it would become apparent to bank depositors and the rest of the European economic periphery that the ECB was not always there to backstop the safety of their deposits.

Heightening the longer-run risk of a Greek exit on the rest of the European periphery is the fact that countries like Italy, Portugal, and Spain are all now characterized by significantly high public debt levels than they were in 2012. They also have very low economic growth and are experiencing strong politically based austerity backlashes. This will make these countries especially vulnerable to speculative attack when global liquidity conditions are not as ample as they are today.

The fourth point relates to the impact of a Greek exit on the United States economy. And here, I would say that there are three basic channels where the United States could suffer considerable economic and geopolitical costs.

The first is that in the immediate aftermath of a Greek exit, one must expect a significant further depreciation of the Euro as the ECB took more forceful measures to deal with the Greek crisis and as investors fled to the safety of the U.S. dollar. The resulting dollar appreciation could continue—constitute a significant headwind to the U.S. economic recovery, particularly considering that we have already had a 15 percent effective appreciation of the dollar over the past year.

Second, over the longer term, any eventual spread of the Eurozone debt crisis to other countries in the European periphery could roil global financial markets. This would be bound to impact the U.S. economic recovery, considering how integrated is the United States in the global financial system, and how important Europe is to the United States as a trade partner.

The third way that a Greek exit could impact the United States is of a geopolitical nature. If a Greek exit leads to a souring of European and Greek relations and to the further erosion of Greek political stability, one could see a failed Greek State increasingly coming into the Russian orbit. This would give Russia a firmer and unwelcome foothold in the Balkans.

The last point that I would like to make is in relation to the IMF, and I would say that a Greek exit would have considerable implications for the IMF's credibility. It would inevitably raise questions as to the design of the IMF's Greek lending programs and as to the IMF's wisdom in loaning unprecedented amounts of money to Greece to keep it in the Euro at all costs, thereby putting the global taxpayer at risk.

It will also be asked why the IMF did not foresee the depth of the Greek economic collapse as well as to what end was Greece put through years of austerity within a Euro straightjacket at the cost of sending its economy into the deepest of depressions when in the end it was forced to exit the Euro.

Thank you, Mr. Chairman.

Chairman KIRK. Professor Slaughter.

STATEMENT OF MATTHEW J. SLAUGHTER, INCOMING PAUL DANOS DEAN, TUCK SCHOOL OF BUSINESS, DARTMOUTH COLLEGE

Mr. SLAUGHTER. Chairman Kirk, Ranking Member Heitkamp, and fellow Members, thank you very much for inviting me to testify on these important and timely issues. My testimony will make

three main points about Greece, one focused on the short-term, one focused on the medium term, and one on the long term.

In the short term, a Greek default would surely inflict additional pain on the Greek economy and on the broader world. One force driving the downturn would likely be the turmoil of reintroducing the Greek Drachma when there are no treaties, laws, or precedents for how to do this. The Greek contraction would dampen economic activity in Europe and, to a lesser extent, the rest of the world, as well.

Through the usual linkages of international trade, however, this scale of dampening would be slight. The basic reason for this is that the Greek economy is quite small. Last year, Gross Domestic Product in Greece was about 240 billion dollars. This was only about one-third of 1 percent of worldwide GDP. In economic terms, Greece is only about the size of Louisiana or Connecticut, fine though those two States are.

The one possible economic impact of a Greek default that might be quite important is the chance that default triggers another world financial crisis. There are sound reasons not to expect such a crisis. For example, today, the majority of Greek sovereign debt is owned not by banks, but rather by public entities. But, no one really knows what will happen in global capital markets if Greece defaults and/or exits the Eurozone. There is simply no historical precedent as a guide.

Before Lehman Brothers died in 2008, wise voices intoned that a medium-size U.S. bank could do little damage. Those wise expectations were proven very wrong. No one can completely rule out such destabilization in the wake of a Greek default.

In the medium term, a Greek default accompanied by an exit from the Eurozone would set a precedent that had been intended to be an impossibility, of a Eurozone member reverting to its own sovereign currency. The main advantage of currency unions like the Eurozone is, or so it is hoped by their creators, eliminating the possibility of the speculative attacks that have so often bedeviled fixed exchange rate regimes, like in the early 1990s turmoil in Europe's exchange rate mechanism, which was a major impetus for creating the Euro in the first place. A "Grexit" would shatter the intended permanence of the Euro and would revive the possibility that Eurozone countries can print their own currencies.

The pressures for additional exits would arise from two forces, potentially interrelated. One is investors demanding higher interest rates from countries they perceive to be possible exitors. The other is fringe political parties, already surging in countries such as Spain's Podemos, that might follow poor policies. The combination of higher interest rates and all the related uncertainty could tend to depress economic growth in certain countries and thereby could trigger a dynamic not unlike that of Greece in recent years.

And any future exits from the Euro would surely bring greater chances of triggering the financial crises described above because of how much larger and interconnected other countries are compared to Greece. Yes, a Grexit might not spark a crisis today, but what about an exit by larger Spain tomorrow or by an even larger Italy?

In the long term, a Greek default is largely irrelevant to the fundamental challenge still facing Greece and every other advanced country, how to foster growth of output, jobs, and incomes in societies with aging populations and looming entitlement pressures. In this sense, the default question is not the most important question facing Greece today. Rather, that honor goes to a different question: Who will be able to foster growth in Greece?

For any country, long-run economic growth requires an ability to accumulate some combination of labor, of capital, and of productivity. What will ultimately create sustainable recovery and hope in Greece is growth in some combination of these factors. For example, Greece's total population fell by about 200,000 over the past decade. Greece today is also saddled with very low levels of innovation and very low levels of research and development spending. Greece's growth problems are a potent reminder to many other countries that poor policies today have consequences that can accumulate far into tomorrow, and those consequences are intensified when talent, capital, and ideas can easily move around the world to where they are welcomed and rewarded.

Lest we all wag our fingers at Greece as uniquely profligate, keep in mind that the dynamic of slowing growth, aging populations, and looming entitlement pressures face many countries, including the United States, where productivity growth has slumped in recent years to many decade lows. In this sense of needing progrowth policies, we in America and in many other countries are not unlike Greece.

In conclusion, wise leaders will reflect on Greece not as a unique outlier, but rather as a sobering leading indicator for the challenges that are approaching many advanced countries around the world, including the United States.

Thank you again for your time and interest in my testimony and I look forward to answering any questions that you may have.

Chairman KIRK. Dr. Reinhart.

STATEMENT OF CARMEN M. REINHART, MINOS A. ZOMBANAKIS PROFESSOR OF THE INTERNATIONAL FINANCE SYSTEM, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY

Ms. REINHART. Thank you, Chairman Kirk and Ranking Member Heitkamp, for the opportunity to comment on the crisis in Greece and its global ramifications.

I will organize my remarks around three topics: Developments in Greece, the impacts of a Greek exit on the European economies, and the repercussions on the United States and global currency markets. My focus is on the near term.

Greece—even if the Greek Government meets its obligations next week, the probability of a default over the summer looms large. I will focus on two reasons why default appears probable.

First, there is a widespread loss of confidence in the sustainability of the status quo that has led to a sharp escalation in internal arrears. The private sector, concerned about the likelihood of an exit from the Euro, has increasingly defaulted on its existing debts. If credit cards are included, three-quarters of the loans in the banking sector are nonperforming. Tax payments are being

postponed. Citizens are hoarding Euros. Bank deposits have fallen around 45 percent since 2009. Banking sector is near a bank holiday. The Government is financing itself by not paying its bills, similar to what transpired ahead of the Russian default of 1998 or Argentina 2001. Government deposits in banks are off around 40 percent.

Second, the 1.6 billion payment due to the IMF next week is only a fraction of the amounts that are coming due in the next 3 months, 20 billion Euro, approximately, some of that to the private sector, largely to the official sector. These payments are a multiple of the cash balances of the central Government and even a multiple of the cash balances of general Government.

Implications for Europe. In my work on contagion, I found that fast and furious financial contagion is more likely when the triggering crisis takes investors and Governments by surprise. There is no surprise here. The Greek drama has been unfolding over years and private sector exposure to Greece, as has already been mentioned, has declined sharply. Prior to the crisis, most Greek debt was held by private external creditors. Such financial links significantly increase the odds of spillovers. Since then, however, official creditors have absorbed the Greek debts.

Real-side exposure to Greece via trade, which is another channel of transmission, as noted, is not a new factor. Greek GDP has already contracted by about 25 percent, and imports, Greek imports, have fallen by even more.

Now, whether investors become indiscriminate and pull out altogether of other European periphery countries remains a risk. However, I would argue that this risk is mitigated by the fact that also a significant share of sovereign periphery debt is in official hands, especially for Portugal and Ireland, and also in the event of such a shock to periphery Europe, I think the official community would support them.

The U.S. The effects of a Grexit on the United States are, in my view, likely to be limited. Financial exposure, which was marginal in the first place, is not a source of concern for financial institutions. Nor is the Greek market a major destination for U.S. exports.

Now, predicting currency fluctuations is an elusive goal for economists, so take my observations with a dose of skepticism. If a Greek default triggers turmoil in Europe, we would expect to see a flight to safety into U.S. dollar assets, notably Treasuries. This has been the response in past waves of global volatility. Further appreciation in the dollar vis-a-vis the Euro and most other currencies would follow. The potential adverse effects of an appreciating dollar would be felt by U.S. manufacturing, not unlike the impact seen already this year.

An appreciating dollar may also act as a headwind in the Fed's efforts to withdraw monetary stimulus and normalize monetary policy. Emerging markets, which we have not mentioned, with dollar denominated debt, would be increasingly vulnerable to further dollar appreciation, as well.

Greece is close right now to financial autarky. The gap between what is a de jure default and a de facto one has narrowed. The

next stage in this crisis may have limited immediate consequences for the global economy.

Thank you.

Chairman KIRK. Thank you.

Dr. Kirkegaard.

**STATEMENT OF JACOB FUNK KIRKEGAARD, SENIOR FELLOW,
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. KIRKEGAARD. Chairman Kirk, Ranking Member Heitkamp, it is a pleasure for me to appear before you to testify on the global impact of what I will say is still a hypothetical Greek default.

In my oral testimony, I will focus on three issues: The near-term situation in Greece; the political nature of the Greek debt structure; as well as the implications of a default on Euro membership and the rest of the global economy.

The current situation in Greece remains in limbo. Negotiations between Greece and the Troika are ongoing and will continue into the weekend. There is, as a result, some risk that Greece will go into arrears against the IMF as early as next week.

However, it remains, in my opinion, a near certainty that an agreement between the Greek Government and the Troika will eventually be found in the coming weeks. The principal question is really whether reaching an agreement will require a brief period of restrictions on deposits in the Greek banking sector or not. Consequently, as things stand now, in the unlikely event that there is no agreement by Sunday evening, we should not, in my opinion, expect Greek banks to open normally on Monday.

The political effects of deposit access control on the Greek economy and financial system would likely be dramatic, and in all probability, in a matter of a few days, lead to significant or sufficient domestic political pressure on the Government to reach an agreement with the Troika.

Given that the Euro area has sufficient retained profits from the security markets program available for potential immediate release, that means without the need to consult national parliament in the Euro area, to the Greek Government in the event an agreement is being reached, any arrears run-up against the IMF would be quickly settled. In my opinion, therefore, any actual default by the Greek Government in the coming days would be of very short duration, measured in only a few days.

Substantial amounts of political brinkmanship are currently being utilized to achieve a negotiated outcome consisting of a quid pro quo agreement between Greece and the Troika of reforms, fiscal consolidation, in return for ongoing financial support. This ultimate ability to find a political agreement with the Greek Government is of the utmost importance, as it suggests that the Greek Government debt levels are today and will most likely in the future remain sustainable, despite the country's extremely high gross Government debt levels and uncertain future growth prospects.

This conclusion follows from the particular current structure of Greek Government debt, which is overwhelmingly owned by the other Euro area Governments and the IMF, while remaining privately held debt is structured at very long maturities with low nominal interest rates. Consequently, the cost of servicing and,

therefore, the financial sustainability of Greek Government debt is largely unrelated to the size of the gross debt or, indeed, financial market fluctuations. Greece already has a substantially longer debt maturity profile and substantially lower implied rates of interest on its debt than, for instance, does the United States Federal Government.

Rather, Greek debt sustainability and ability to avoid a future default is dependent on principally two things: The Greek Government's ability to restore economic growth in the country, or, in other words, the continuation of growth-friendly structural economic reforms; and the country's ability to reach an ongoing political agreement with its official sector creditors in the Euro area and the IMF.

Unlike the rules-bound IMF, the Euro area, which has already been done in June 2011, March 2012, and November 2012, has the political freedom to ex post restructure its holdings of Greek Government debt in a manner sufficient to maintain debt sustainability for the country and closely calibrated to the preceding degree of Greek Government delivery of agreed structural reforms and fiscal targets. In short, Greece is and will remain solvent if its own Government and the Euro area wants it to be.

Now, in the event that a Greek Government nonetheless does default, it will quickly prove an economic disaster for the country, as it loses not only ECB banking sector liquidity support, ongoing financial support from the Troika, but also net ongoing budgetary transfers from the EU budget consisting to roughly about 3 percent of GDP on an annual basis.

At the same time, it is important to recognize that any default by Greece will not likely lead to an exit from the Euro area as there, first of all, is no public support for such a momentous decision in Greece, and under any scenario it likely will prove impossible for the Greek Government to successfully reintroduce a new national currency side-by-side with the Euro. Rather, in my opinion, the country risks ending up a little bit like the country of Montenegro, which unilaterally Euro-ized its economy in 2002 in a manner similar to, for instance, how Ecuador and El Salvador have fully adopted the United States dollar. Attempts at implementing a Grexit, therefore, will de facto mean that Greece will only leave the institutions of the Euro area and the EU, not the currency itself.

Finally, let me quickly note that Greece is a small country consisting of only 1.8 percent of Euro area GDP, and, therefore, as a result of also improving Euro area economic performance, a more resilient institutional structure in the Euro area, and not least, additional likely ECB monetary stimulus in the event of a default by Greece, any cross-border contagion spillover is likely to be contained. As a result, therefore, a hypothetical Greek default does not pose systemic risks to either the Euro area or the global area at large.

Thank you very much.

Chairman KIRK. Let me ask the first question to the panel. I wanted to ask you what we would call in the John McLaughlin days the mega-question. How likely is the Greek crisis to actually hurt the U.S. economy, in your view?

Mr. KIRKEGAARD. Well, following from my testimony, I believe that probability is very, very low, because I do not believe, as I said, that there will be a default by Greece, but rather that—

Chairman KIRK. Let me follow up on that. Understand this crisis right now is a crisis of Greece being unable to repay the IMF 1.7 billion dollars that they owe on the latest 25 billion dollar loan that the IMF extended to Greece, and that payment is due on June 30. To fuzz over the differences, I think IMF will declare that Greece is in arrears. They will not use the “d” word, which might be too alarming. Is that what we are facing?

Mr. KIRKEGAARD. In my opinion, that is correct, yes, and I think running into arrears against the IMF does not, in my opinion, have any implications, really, for the short-term operation of the IMF. You know, we are basically—and this is in my written testimony—it will merely—merely, I say—double the current outstanding arrears that the IMF memberships to the institution so that we go back to levels of actual arrears by the membership at the IMF that we saw last in the early 1990s. So, it would not be an unprecedented situation, by any means.

Chairman KIRK. If we look at the forward commitment authority for the IMF to be able to take on further and make other loans, my understanding, they have about 421 billion dollars left in their forward commitment authority. Is there any chance that a European crash that could wipe out IMF’s forward commitment authority, basically making them unable to respond in a major way to a big crisis?

The thing that I worry about is—you guys are far more expert on this. I remember in the Mexico crisis when the Mexican collapse was so big that it exceeded the abilities of the international financial institutions to help out. And, you can correct me if I am wrong. I remember it was the U.S. Fed that had to step in directly. Is that wrong?

Mr. KIRKEGAARD. [Off microphone.]

Chairman KIRK. Yeah. At that point, we would think that in the case of contagion or collapse, then the U.S. exposure is high.

Ms. REINHART. I do not really see the U.S. exposure in the current context as being high on the financial side or on the real side. I think the greatest risk are those that some of us have already alluded to, which is another round of dollar appreciation in the context of a flight to U.S. assets.

Chairman KIRK. Just let me point out that I mentioned the case of official debtors like Stockton, California, and Detroit, Michigan, and the State of Illinois, and the Chicago Public School System. How much does this Euro problem interfere with municipal and State debt overhanging the bond market in the United States?

Ms. REINHART. I am not an expert on the municipal market or the subsovereign debt, but the parallel—there are important parallels and differences. The biggest difference is, of course, no State in the United States is facing the bank runs prospects that Greece currently has. The biggest parallel is the need to avoid the hidden debts or the arrears which are a major issue internally in Greece now. So, technically, one could say, Greece has domestic default already.

Chairman KIRK. Desmond, I would note that under U.S. bankruptcy law, a United States State cannot declare bankruptcy. There is no provision in our code.

Mr. LACHMAN. Yes. Let me just say that I do not share the sanguine view being expressed that this does not have the potential to cause real problems for the United States, not immediately, but down the road. We are talking about something hugely significant, is that one member of the Euro could be leaving the Euro as a currency. That shows that the Euro does not last forever, and that can throw focus in times of different liquidity conditions on a country like Italy that has 2.5 trillion dollars of debt. It is the third-largest debtor, and by any means, Italy's debt is not sustainable. This is a country that has not grown for 15 years. It has got a debt-to-GDP level of 135 percent.

In regard to your question on the municipal market, what has to be of concern is that these Greek events are playing out at the same as events are playing out in Puerto Rico. Puerto Rico has 73 billion dollars of debt. It is going to have payments due in July to its electric company. It has got other payments to the National Bank in September. Markets are thinking that the chances of Puerto Rico making these payments are very slim. So, what you could get is you could get two big bankruptcies playing simultaneously, and I do not think any of us knows how that might affect the municipal market, but it is an event that I do not think we can just gloss over.

Mr. SLAUGHTER. Senator—

Chairman KIRK. When you mentioned Puerto Rico, you are now kind of scaring me a bit. I was just watching the European situation. If we look at the market and how it would see a Puerto Rican default around the same time of a Greek default, do you have potential contagion there?

Mr. LACHMAN. Yes, that markets—you know, that you think that there is going to be a repricing in the markets. You know, that is just looking at the electric company in Puerto Rico, that has alone got nine billion dollars of debt. That is a bigger default—would be a bigger default than was for Detroit. You know, you have got another 73 billion dollars there. So, markets—this is widely held, and it looks like that is another intractable situation.

Mr. SLAUGHTER. Senator, if I could add to that, the one thing that is not known well is when you start to think about these capital market price changes, who owns what assets and whether it is a pension fund or a hedge fund or a particular bank, how leveraged they might be. I think a common theme here is through the usual flows of international trade in goods and services, there is not that large of a risk to the U.S. economy. The small probability of a potentially very large risk comes through these capital market linkages.

Chairman KIRK. Anybody else? Desmond Lachman.

Mr. LACHMAN. I think I would add that I very much agree with Carmen that the usual channels of contagion might not be in play immediately in the case of Greece, but you do have problems with bank deposits that could be moving on a big scale. You know, if one sees that the Greek bank depositors lose their money, that the European Central Bank was not there to backstop them, you would

expect that deposits will start leaving the other countries in the periphery, namely Italy and Spain, and that could cause a huge problem. So, contagion can take place in different ways in this crisis.

I am not expecting this to occur immediately, but just looking at Europe with all of its political problems, with a series of elections the next 6 months, I do not think that one can dismiss the chances that something could go very wrong.

Chairman KIRK. Ms. Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman.

You know, there is an old expression, do not go looking for trouble. Trouble will find you. And, I think, in part, we are in that spot where what we look at when we look at numbers is that this is the chance of catastrophic contagion in the near term. Certainly by the majority of testimony here, it does not exist.

I am intrigued by the dollar value, which has obviously a very dramatic impact on any State that produces commodities and relies on exports. We are already challenged in the export area because of a high dollar value. I am intrigued by that.

I have been thinking all along about this hearing and about the significance of trying to track the impact on the American economy, and it seems to me that of all the things that I have heard today, that is probably the thing that raises the—again, another rush to a safer currency, a safer economy, which is right now the American economy.

But, Dr. Kirkegaard, if I can ask you to kind of respond to some of what you have heard here as it relates to the immediate impact. I know you have already testified, but if you were going to look more than the near term, which is a lot of what the discussion that we have had, and look down the road a couple years into the future, what needs to change to stabilize the overall Eurozone, but particularly those economies like Greece that are challenged at this point with low growth rates? What do we need to do?

Mr. KIRKEGAARD. Well, I think, first of all, what Greece needs to do is to avoid defaulting, because if it defaults, it will lose access to the European Central Bank very quickly, as I said. If there is no agreement over the weekend, I will predict you will have deposit controlled in the country, which sets in motion another very, very dramatic economic decline.

Senator HEITKAMP. And as we have heard earlier from earlier testimony on this panel, we are already seeing some of that flow. We are already seeing some of that withdrawal from regular banking institutions, correct?

Mr. KIRKEGAARD. Yes. But, I will stress, though, that in some ways, in my opinion, what is actually remarkable is that there is still by the latest data approximately 120 billion Euros left in the Greek banking system and it has not—we have not seen deposit withdrawals in any of the other Euro area countries.

And, I must say that I am personally quite skeptical that we will see this, even in the event that there is a Greece default, because I think as we look forward, we have to recognize that this will be a very dramatic and traumatic experience for the Greek economy and the Greek population, despite that they have already, of course, suffered tremendously. If they default, things will get a lot worse.

But, if you are looking at Greece in other countries, and I mean Podemos and other political movements in Spain and elsewhere were mentioned, we have to ask ourselves, what is the lesson that you then draw from events in Greece? Is it that you should follow the policies of the current Government and take your country into such a catastrophic path? I would argue that it is not, that, in fact, if Greece is going to default, which, as I said, is not what I think will happen, but were to happen, I think other populations in Europe will look at that and they will draw the conclusion that this is not the right way to go. So, I think we should be very careful in over-dramatizing the political contagion from current events in Greece.

And, I would also say that the sometime expressed notion that if Greece were to leave the Euro area, it would automatically turn the Euro into a so-called fixed exchange rate regime, which is, of course, a much brittler or less solid entity I also believe to be conceptually flawed, because what we are looking at here is actually not the collapse, inevitable collapse of the Euro area following one country's exit, but it is actually rather the difficulties, as I alluded to in my initial testimony, of Greece actually succeeding in introducing a new currency, because the Euro will still be there and you are trying to institute a new currency, the new Drachma or whatever we call it, side by side with the Euro.

And, I do not think the current Greek Government is going to be able to institute anything, any new currency, that actually retains the function as a store of value in that currency—

Senator HEITKAMP. Right.

Mr. KIRKEGAARD. —which means that we are not looking, therefore, from experiences from previously collapsing currency unions, you know, the Soviet Union or Yugoslavia or things like that, but, rather, we are looking at something which has not happened before in history. As far as I know, there is no example of a country that have fully dollarized, for instance, and actually reversed that decision.

Senator HEITKAMP. OK. I think those are all important parts.

And, if I can just make another point from the original panel's testimony. Dr. Slaughter, I think you mentioned the lack of innovation, the lack of investment in, you know, aging populations, the lack of investment in research and development, and part of that is driven by this immediate move toward austerity. And, so, when we look at the austerity measures, it is kind of, like, where is the appropriate balance? Obviously, we all know that in a spending crisis, in a fiscal crisis, you need to make those adjustments. But, one of the things that you said that concerns me is the amount of GDP that is spent in investment and the things that we normally say will be leading indicators for growth in the future.

Looking at this, what is happening in Greece and looking across kind of all the economies, how do you measure that balance between austerity and fiscal responsibility?

Mr. SLAUGHTER. Great question, Senator. I think a couple things come to mind. One is, and it connects with your earlier question about what happens in the next year or two, in some basic sense, I think, part of the challenge for Greece is of its elected and appointed Government officials, all of their time and energy and then

some is spent kind of day to day with the crisis issues that we have been speaking to here. And I think the policy issues that speak to more sustainable economic growth—no fault, but an observation—simply are not being talked about there.

So, what ideally would happen in the near term of the next couple years is some regulatory form would be put into place by the Greek parliament to introduce private capital, in particular, to help stimulate some of the research and development and economic activity that we are talking about.

To their credit, Greece has made some substantial progress on this in the past couple years despite the crisis. So, the World Bank has—it is doing business rankings that it assembles. Greece's position in the World Bank's doing business rankings has risen from 109 in 2011 to 61 today, one of the largest increases of any country on the planet. So, they have made some progress, and many countries in Europe and elsewhere think of the Irish experience over the past 30, 40 years. A lot of the growth in jobs and opportunity come from international investors coming in to build new businesses, to make those investments in jobs.

So, you have got agriculture, you have got tourism, you have got some industries in Greece that have more potential, and hopefully, that is something that will flourish more in the years ahead.

Senator HEITKAMP. Well, and that is the challenge, not destabilizing the economy to the point that you cannot attract—

Mr. SLAUGHTER. Exactly.

Senator HEITKAMP. —international investment—

Mr. SLAUGHTER. Exactly.

Senator HEITKAMP. —and there we are.

Mr. SLAUGHTER. Yes.

Senator HEITKAMP. And, I only say this, not that it is our job here in the U.S. Congress to try and help Greece achieve the appropriate balance, but I think in a much smaller scale, we are in that same discussion here with the American economy, which is how do we—with sequestration, which is a form of austerity—

Mr. SLAUGHTER. Right.

Senator HEITKAMP. —how do we make those appropriate balances. And, so, it is informative and I really appreciate your testimony. I thought it was very timely and topical and important to hear.

Chairman KIRK. Thank you.

Senator HEITKAMP. I think Dr. Lachman—

Chairman KIRK. Let me ask Desmond, who was about to jump in here—

Senator HEITKAMP. Yes.

Chairman KIRK. If you look at this chart, you will see the debt list through 2055. Do we look at a grim long-term future of almost no economic growth in this market overhung by debt?

Mr. LACHMAN. Yes. Greece's debt, you know, the level that it has reached, now it is 175 percent of GDP. By any measure, the country is insolvent. It really needs debt relief of one sort or another. You need not write down the face value. You could extend the maturities 100 years and give them interest rates of zero, you would get the same kind of effect.

But, the point I just wanted to make on fiscal austerity, which I think is really crucial and it is the lesson of Greece, is that it is very difficult to balance one's budget to bring down big deficits when you are in a fixed exchange rate system and you do not have monetary policy that is an offset to the fiscal tightening. So, what has occurred in Greece is that they have tried to tighten the budget, but they cannot devalue the currency to boost exports or to pump money into the system to offset the effect of the belt tightening, and that has proved to be counterproductive.

And, my fear is that the kind of policies that they are discussing with Greece right now are very much more of the same. They are looking for as much as 2 percentage points of GDP or fiscal adjustment over the next 12 months and another 4 percent of GDP over the medium term and they are going to be again doing it in a European Euro straightjacket that does not allow it to—an offset, and that is, I think, a very big difference than our situation in the United States. I am not saying that getting the budget into balance is an easy thing in the United States, but it is a lot easier if you have got a Federal Reserve that is pumping money into the system, cheapening the dollar, making this thing possible.

Senator HEITKAMP. So, it is a lot easier when you control both the fiscal policy and the monetary policy.

Mr. LACHMAN. Absolutely, that if you are trying to do this—if you are just putting your foot on the brake and the car already is slowing down at a rapid rate, and, you know, you talk about a country that has had GDP declining by 25 percent and they have not brought down their debt, it has been counterproductive, what they have been doing.

Senator HEITKAMP. I think, Dr. Reinhart, you had a comment you wanted to make. I could see you kind of leaning in there.

Ms. REINHART. One piece of information that I think is relevant to this discussion is we are treating the Government in Greece as if what the Government will do. We really have little idea what the Government may be. Argentina had five different Governments within a year-and-a-half during its major crisis. So, that is another source of uncertainty. And, so, I think that the larger issue of restoring growth is also very, very deeply rooted to all the levels of uncertainty that we are dealing with, not just economic, but political, as well.

Chairman KIRK. Dr. Reinhart, let me follow up by talking about the foreign policy implications here. When we look at Russia and her position as a creditor, does she have a significant ability to come in as a white knight asking for ridiculous things, like Greece's departure from NATO or something like that? Do they have that flexibility?

Ms. REINHART. Russia has its own significant—significant, let me reiterate—economic problems. They have lost a massive amount of reserves. They still have quite a reserve stockpile, but they are in deep recession. The ruble depreciation has not really helped them, given sanctions, given oil prices. And, I would say that if we were to look back to what position Russia was in 3 years ago, that might have been the case. But, I think, in the current context, I do not see them giving away their precious reserves, or what remains of them, to assist the Greek Government.

Chairman KIRK. Dr. Lachman.

Mr. LACHMAN. I am not sure that the Greek Prime Minister shares that view, because otherwise, I am not sure what he is doing so frequently in Moscow, talking about building of a pipeline that is going to go through Greece to take the gas, talking about possible loans from Russia. Russia has got a lot in this game, is that Greece is a member of Europe and in order for Europe to maintain sanctions on Greece—on Russia, they need Greece's consent. So, there is a trade in the making and the Russians will play a long game.

Russia right now is hurting because the price of oil is where it is, but one does not know whether the price of oil is going to stay here for a long time and Russia will play a long game with the Greeks. I am not sure that we should just disregard what can occur in so strategic a part of the world as the Balkans.

Senator HEITKAMP. Dr. Kirkegaard.

Mr. KIRKEGAARD. I think I would just strongly support what Carmen said, which is that Russia does not have the financial capacity, in my opinion, to really provide the kind of financial assistance that Greece would need if it were to default against its current Troika members, because it will lose literally hundreds of billions of Euros in liquidity support from the European Central Bank, and that kind of money, Vladimir Putin does not have.

And, I would also say that with respect to the sort of ongoing diplomacy that we see, I regard it as politically not very wise of the Greek Prime Minister to fly to Moscow that often. But, if we look back at previous instances of this kind of flirtation between European countries and the Russian Government, we say it in Cyprus in 2013, where the then-Cypriot president tried to fly to Moscow and ask for—and this was when Vladimir Putin was in a much better financial position to provide that support—and ask for Russian money rather than take a Troika bailout and he got nothing. So, I would very strongly caution that actually Vladimir Putin is going to put any money into this. I do not think he is going to do that under the current circumstances.

And, therefore, this geopolitical threat that Russia poses in Greece, I think it should also be kept in mind that the EU sanctions were, in fact, extended by 6 months just a few years—a few days ago during a process in which the Greek Government did not pose any problems of any kind actually at the negotiating table. And, so, I think this is a little bit getting ahead of ourselves if we think there is a real risk here.

Chairman KIRK. Well, I would like to thank all of our witnesses very much for everybody coming. I thank my Ranking Member for participating in what has been a very good hearing to make sure the markets are not surprised and we can limit contagion in this problem.

With that, I would like to adjourn here.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF DESMOND LACHMAN

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

JUNE 25, 2015

Thank you Chairman Kirk, Ranking Member Heitkamp, and Members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

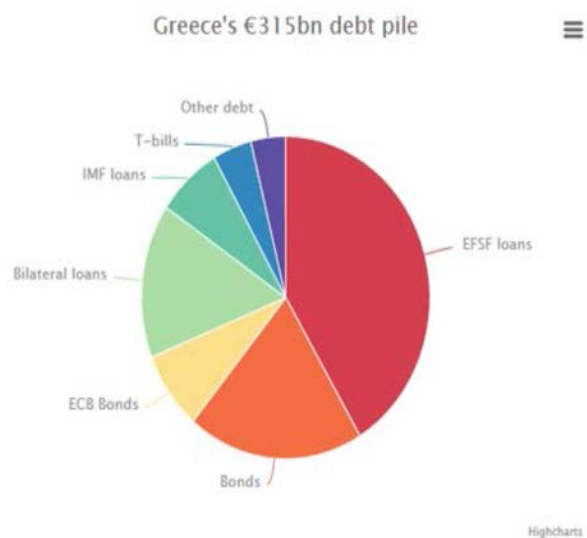
Introduction

Recent economic and political developments in Greece suggest that it is only matter of time before that country both defaults on its large public debt and imposes capital controls. Those developments could very well pave the way for Greece's exit from the Euro within the next 12 months. Were that to occur, one must expect that Greece's economic and political crisis will deepen, which could lead to that country becoming a failed State.

Europe is in a very much better position today than it was in 2012 to handle the immediate fallout from a Greek exit. However, a number of countries in the European economic periphery continue to experience weak economic growth at a time that they still have very high public and private sector debt levels. This makes them especially vulnerable to swings in investor sentiment once global liquidity conditions are normalized and once the perception becomes widespread that Euro membership is no longer irrevocable.

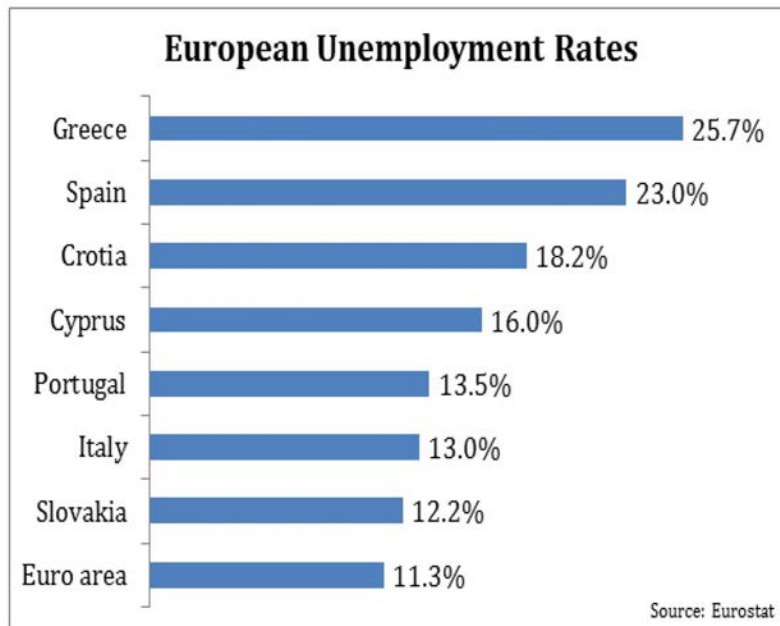
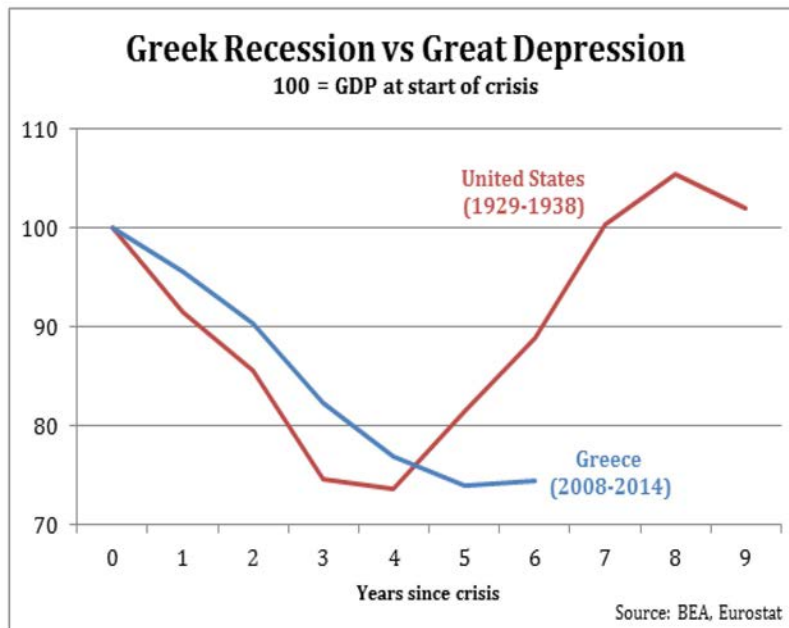
The implications of a Greek default for the United States are not to be underestimated. Immediate action by the European Central Bank (ECB) to limit contagion to the rest of the European periphery must be expected to further significantly weaken the Euro against the dollar that could have a material impact on the U.S. trade balance. From a longer term perspective, should market financing for a country as highly indebted as Italy dry-up in the wake of a Greek exit, one should expect renewed tensions in global financial markets that could constitute a significant headwind to the U.S. economic recovery. In addition, were Greece to become a failed State, a geopolitical price might be paid in the sense that Russia would have an opportunity to gain a firmer foothold in the Balkans.

A deepening of Greece's economic and political crisis would further dent the credibility of the IMF, which has provided major financial support to Greece over the past 5 years and which has consistently underestimated the depth of the Greek economic depression. It could also result in Greece's defaulting on the US\$24 billion it owes to the IMF, which could have implications for the U.S. taxpayer.



Greek Economic and Political Backdrop

Over the past 6 years, Greece has experienced an economic depression on the scale of that experienced by the United States in the 1930s. Its economy has contracted by around 25 percent, its unemployment rate has exceeded 25 percent, and its youth unemployment has risen to over 50 percent. At the same time, despite 5 years of budget austerity and a major write-down of its privately owned sovereign debt, Greece's public debt to GDP ratio has risen to 180 percent.



At the heart of Greece's economic collapse has been the application of draconian budget austerity within a Euro straitjacket. That straitjacket has precluded exchange rate depreciation or the use of an independent monetary policy as a policy

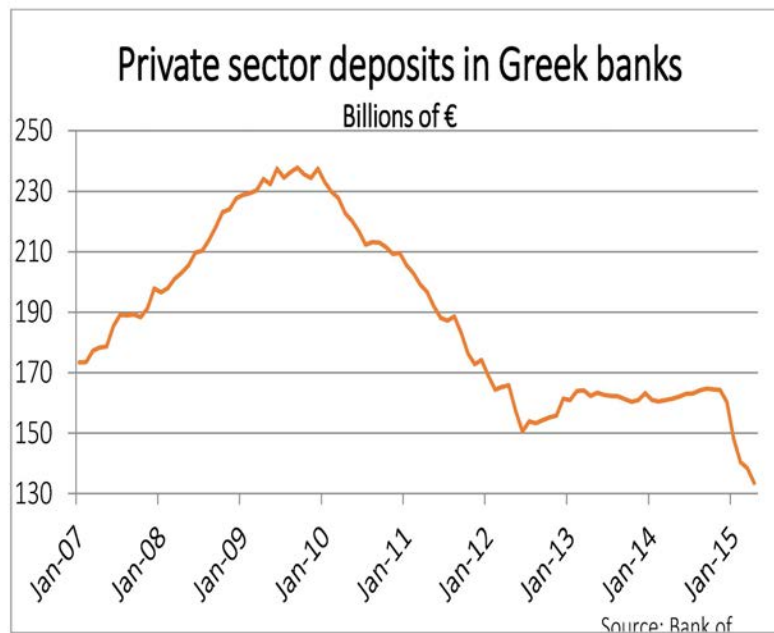
offset to the adverse impact of budget belt-tightening on aggregate demand. To its credit, the IMF has conceded that in designing its economic program for Greece it had grossly underestimated the size of the Greek fiscal multipliers.

The deterioration in Greece's economy has given rise to the fragmentation of its politics and to a major anti-austerity backlash. This has been underlined by the decline in support for, Greece's two establishment political parties, New Democracy and PASOK from 70 percent in 2010 to around 25 percent at present. It has also been underlined by the rise of extreme political parties on both the right and the left side of the political spectrum as well as by the coming into office of the far-left Syriza Government in January 2015. That Government came into office on a platform of reversing the policies of budget austerity and structural economic reform that have been imposed on Greece by the IMF and Greece's European partners.

Negotiations With Its Creditors

Over the past 5 months, the Syriza Government has been engaged in difficult negotiations with the IMF and EU on the release of much needed funds from its borrowing arrangement with those institutions. Until very recently, those negotiations have been characterized by large differences in positions over additional budget austerity and over pension and labor market reform that Greece's creditors are demanding of Greece in return for the release of those funds.

Since end-2014, in an atmosphere of heightened political uncertainty, Greece's economy has taken a renewed downturn while its public finances have moved from a small primary budget surplus to a primary budget deficit. At the same time, the Greek banking system has experienced a slow run on its bank deposits. These deposits have now fallen by around 20 percent since the start of the year and have required substantial European Central Bank support to keep the Greek banking system afloat.



This week the outlines of an agreement between Greece and its official creditors finally appears to be emerging that could release the funds so desperately needed to avoid a Greek default on the IMF and the ECB. However, it is highly questionable how long such an agreement will last. An essential component of that agreement appears to be yet another 2 percentage points of GDP in fiscal tightening over the next year and as much as 4½ percentage points of GDP in tightening over the medium term. A further weakness of that agreement is that it relies almost exclusively on tax increases to achieve its budget objectives and that it sorely lacks either pension or labor market reform that are much needed to promote economic growth.

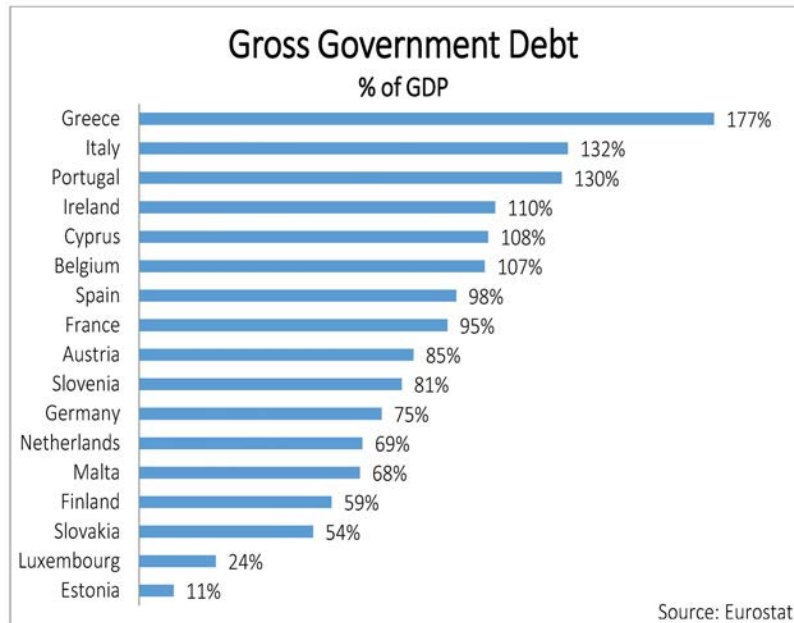
If past is prologue to the future, such an amount of budget tightening in a Euro straitjacket and such a high reliance on tax increases is almost certain to deepen Greece's economic depression. That in turn again risks putting the country's budget objectives out of reach. It also risks splitting the Syriza Party, which is already divided on the question of persisting with budget austerity and structural economic reform.

Containing Contagion

Europe is in a very much better position today than it was in 2012 to handle either a Greek default or a Greek exit from the Euro. It now has in place a EUR 500 billion European Stability Mechanism that can provide adequate financing to any Eurozone member that might come under market pressure. More important yet, the ECB now has in place an Outright Monetary Transaction facility that should allow it to do "whatever it takes" to maintain market stability in the event of a Greek exit. This should enable European policymakers to ring-fence the initial fallout from any eventual Greek exit, albeit at the probable cost of having to resort to the ECB's printing press.

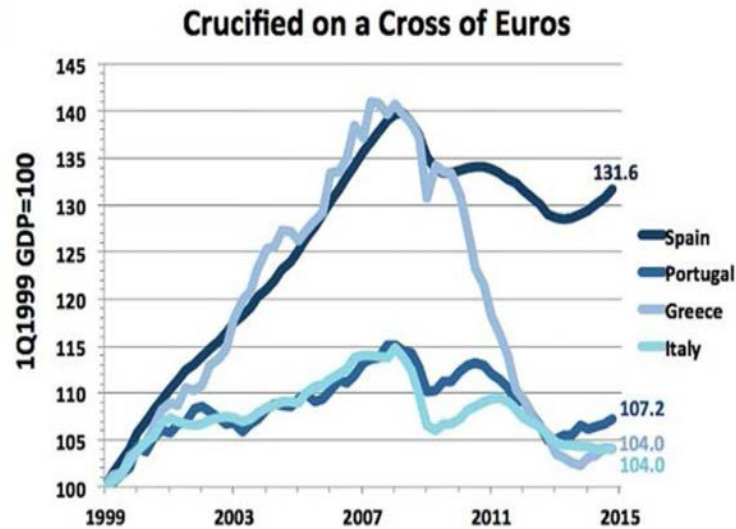
While European policymakers now appear to be well-equipped to handle the immediate fallout from a Greek exit, they do not appear to be so well positioned to deal with the longer run damage that a Greek exit might cause to the Euro project. A Greek exit would signal very clearly to markets that Euro membership was no longer irrevocable. In addition, in the wake of large losses by Greek bank depositors, it would become apparent to bank depositors in the rest of the European economic periphery that the ECB was not always there to backstop the safety of such deposits.

Heightening the longer-run risks of a Greek exit on the rest of the European periphery, is the fact that the periphery is now characterized by significantly higher levels of public debt to GDP ratios than in 2012. It is also of concern that these countries remain characterized by very low growth rates and by price deflation, which makes it very difficult for these countries to grow their way out from under their debt mountains. In that respect, it does not help that countries in the economic periphery are all experiencing political backlashes against further budget austerity and structural economic reform.



Italy's present position is particularly disturbing considering that the country has more than US\$2½ trillion in public debt, making Italy the world's third largest sovereign debt market. Whereas at the start of the debt crisis in 2010, Italy's public

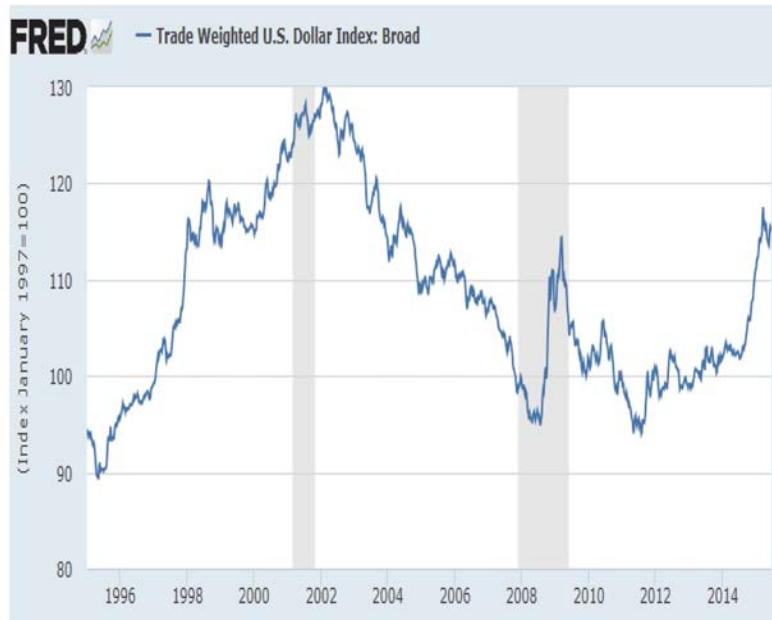
debt to GDP ratio was 115 percent, today that ratio is around 135 percent. Meanwhile, since 1999 the Italian economy has shown no growth. It should perhaps come as no surprise that all of Italy's major political parties, other than the governing Democratic Party are now opposed to Euro membership. This is bound at some stage to turn the market's focus on Italy's shaky public debt dynamics.



Implications for the United States

Over time, a Greek exit could impose considerable economic and geopolitical costs on the United States. This could occur through the following three channels:

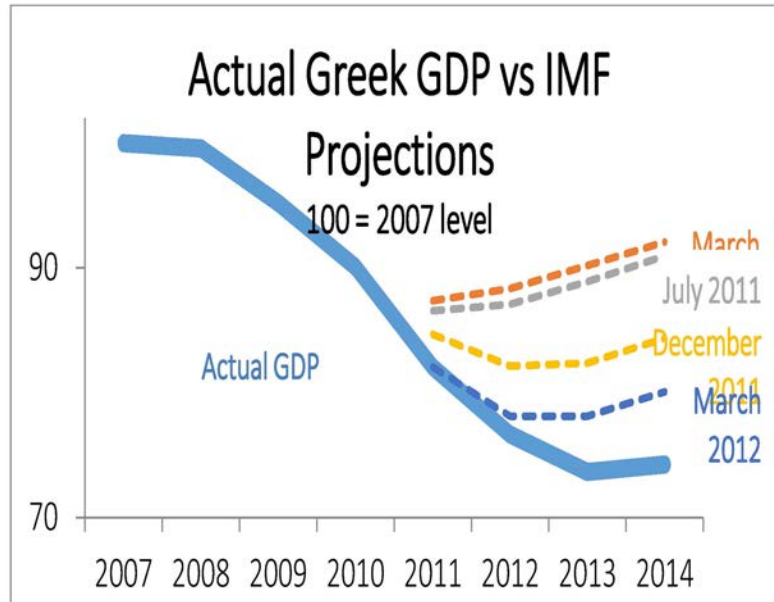
- a. In the immediate aftermath of a Greek exit, one must expect a significant further depreciation of the Euro as the ECB took more forceful measure to prop up the European periphery and as investors fled to the safety of the dollar. This would have the effect of causing a further effective appreciation of the dollar that would come on top of a 15 percent such appreciation over the past year. As the Federal Reserve has noted, a strong dollar appreciation could constitute a significant headwind to the U.S. economic recovery and could exert significant downward pressure on U.S. headline inflation.



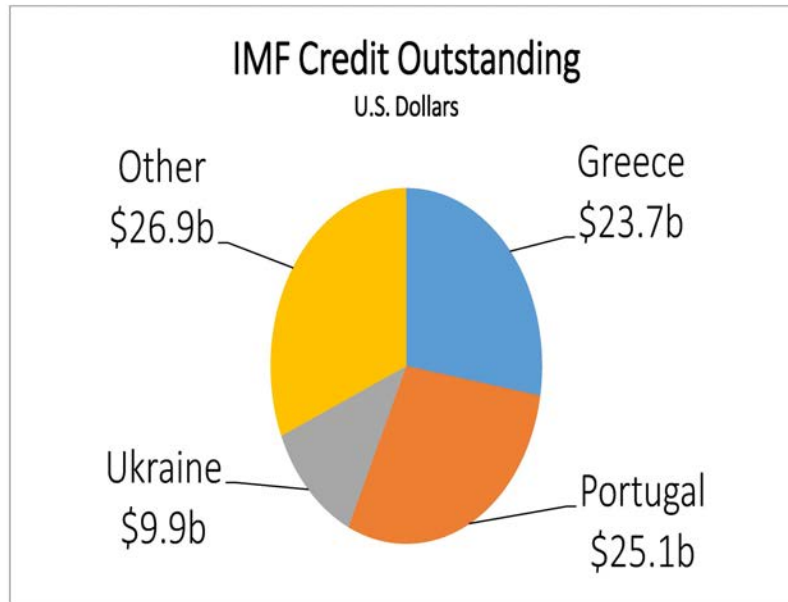
- b. Any eventual spread of the Eurozone debt crisis to other countries in the European periphery, like Italy, Portugal, and Spain, could roil global financial markets and dent European household and investor confidence. This would be bound to impact the U.S. economic recovery considering how integrated is the global financial system and how important the European economy is to U.S. trade.
- c. Should a Greek exit lead both to a souring of European-Greek relations and to the further erosion of Greek political stability, one could see a failed Greek State increasingly coming into the Russian orbit. Already the Syriza Government is actively engaged with Moscow about the construction of a Russian gas-pipeline through Greece despite the U.S. Administration's objections. A deepening of the Greek economic crisis is all too likely to bring Athens and Moscow closer together.

Consequences for the IMF

A Greek exit would have considerable implications for the IMF's credibility. It would inevitably raise questions as to the design of the IMF's Greek lending programs and as to the IMF's wisdom in loaning unprecedented amounts of money to Greece to keep it in the Euro at all costs. It will also be asked why the IMF did not foresee the depth of the Greek economic collapse as well as to what end was Greece put through years of austerity within a Euro straitjacket at the cost of sending its economy into a deep depression, when in the end it was forced to exit the Euro.



A Greek exit is also likely to involve Greece defaulting on the US\$24 billion that the IMF has loaned to it. This would be of considerable concern considering that Greece together with Portugal and Ukraine account for around two-thirds of the total IMF loans presently outstanding. This will make it difficult for the IMF to make the case to Congress that U.S. taxpayer money was not put at considerable risk by the IMF's lending practices.



It will also make it difficult for the IMF to defend its “exceptional access” lending policy that in effect removes limits on how much money the IMF can loan to an individual country. This will be particularly the case considering that over the past few years, very large scale IMF lending to Greece forestalled much needed debt restructuring in that country. In the process, it facilitated the exit of private sector creditors from that country by placing the global taxpayer very much on the hook in the event of a Greek default.

PREPARED STATEMENT OF MATTHEW J. SLAUGHTER

INCOMING PAUL DANOS DEAN, TUCK SCHOOL OF BUSINESS, DARTMOUTH COLLEGE

JUNE 25, 2015

Introduction

Subcommittee Chairman Kirk, Ranking Member Heitkamp, Committee Chairman Shelby, Ranking Member Brown, and fellow Members, thank you very much for inviting me to testify on these important and timely issues of how a default by Greece on its sovereign debt would impact the United States and overall global economy.

My name is Matt Slaughter, and at the Tuck School of Business at Dartmouth I am the incoming Paul Danos Dean, the Earl C. Daum 1924 Professor of International Business, and the founding Faculty Director of the Center for Global Business and Government. From 2005 to 2007 I also served as a Senate-confirmed Member on the President’s Council of Economic Advisers, where my international portfolio spanned topics such as currencies, international trade and investment, and the competitiveness of the U.S. economy.¹ More recently I was a founding member of

¹In the past 2 years, I have not received any Federal research grants. In addition to the above Tuck positions, currently I am also a Research Associate at the National Bureau of Economic Research; an adjunct Senior Fellow at the Council on Foreign Relations; a member of the advisory committee of the Export-Import Bank of the United States, a member of the academic advisory board of the International Tax Policy Forum; and an academic advisor to the McKinsey Global Institute. For many years I have consulted both to individual firms and also to industry organizations that support dialogue on issues of international trade, investment, and taxation.

Continued

the Squam Lake Group, a nonpartisan group of 15 academics who came together to offer guidance on reform of financial regulation amidst the World Financial Crisis.²

At the time of writing this testimony, the outcome of the latest chapter of the Greek-debt saga is still being written. Prime Minister Alexis Tsipras has just flown to Brussels to meet with fellow Government leaders, at least some of whom have objected to his latest compromise offer. There are many fluid and undefined issues about the immediate situation, none of which this testimony will address. Rather, I will make three main points about the consequences of a Greek default: one focused on the short term, one focused on the medium term, and one on the long term.

1. In the short term, a Greek default would surely trigger additional short-term pain on the Greek economy. Through various channels, it would very likely dampen overall economic activity in the Eurozone—and thus, albeit to a lesser extent, the rest of the world. And, there is some small but nonzero chance that it would trigger another world financial crisis of the magnitude of the World Financial Crisis of 2008–2009 triggered by the default of the U.S. investment bank, Lehman Brothers.
2. In the medium term, a Greek default would raise the risks of additional highly indebted and struggling countries exiting the Eurozone. This elevated risk would tend to dampen economic activity within Europe and beyond, through channels similar to those cited above. And, arguably even more than Greece—because of how small it is—these future exits would bring greater chances of triggering financial crises.
3. In the long term, a Greek default is largely irrelevant to the fundamental challenge still facing Greece and every other advanced country: how to foster growth of jobs, incomes, and output in societies with aging populations and looming entitlement pressures. The current Greek crisis, however it is resolved, does nothing to address this fundamental long-term problem facing much of the global economy. Indeed, by crowding out the attention of policy and business leaders, the current crisis aggravates this looming long-term problem.

The Short-Term Default Consequences: Definite Economic Downturn, Possible Crisis

In the short term, a Greek default would surely trigger additional short-term pain on the Greek economy. In the past 5 years Greece has sustained a Great Depression-scale contraction. Gross Domestic Product has fallen by nearly 30 percent. Unemployment spiked to about 26 percent, with unemployment of those aged 25 and younger peaking at a staggering 50 percent. Nearly all wages have fallen by double-digit percentages. That said, in the past year many economic indicators have stabilized and some have turned positive. For example, GDP has expanded slightly.

In whatever form it might take, a default would contract the Greek economy further. A main contractionary mechanism would likely be a wave of bank runs and thus bank closures, with knock-on bankruptcies beyond the financial sector, amidst the turmoil of reintroducing the Greek Drachma when no treaties, laws, or precedents for how to reconvert all payment flows, assets, and liabilities out of Euro denomination. This turmoil would sharply curtail consumption and investment demand in Greece, which in turn would drive down short-term output and employment. The scale of this contraction is difficult to predict, but double-digit declines are conceivable. Over time, recovery in Greece would be facilitated by a sharp devaluation of the drachma relative to the Euro and to other global currencies—and thus a boost in export demand as Greek goods and services (such as tourism) become less expensive to foreign customers. This export fillip would almost surely be swamped in the short term, however, by contractions in consumption and investment demand.

This Greek economic contraction would very likely dampen overall economic activity in Europe—and thus, albeit to a lesser extent, the rest of the world. Through the usual linkages of international trade and investment, however, the scale of this worldwide dampening would be slight. The basic reason for this is that the Greek economy is quite small. 2014 GDP in Greece was about \$244 billion (down from a

²For a listing of such activities, please consult my curriculum vitae posted on my Web page maintained by the Tuck School.

³The book our Group coauthored that discusses the challenges in understanding and aiming to prevent financial crises is *The Squam Lake Report: Fixing the Financial System*, with Kenneth R. French, Martin N. Baily, John Y. Campbell, John H. Cochrane, Douglas W. Diamond, Darrell Duffie, Anil K. Kashyap, Frederic S. Mishkin, Raghuram G. Rajan, David S. Scharfstein, Robert J. Shiller, Hyun Song Shin, Matthew J. Slaughter, Jeremy C. Stein, and Rene M. Stulz; Princeton University Press, June 2010.

precrisis peak of about \$342 billion). This was about one third of 1 percent of world-wide GDP in 2014 (\$77.3 trillion, according to the International Monetary Fund). Greece is about the size of the economy of Louisiana or Connecticut. As such, however large a default-induced contraction in Greece might be, it simply would not be very large relative to the overall world economy. A further 10 percent contraction of the Greek economy would be about $\frac{1}{30}$ th of 1 percent of the total world economy.

The knock-on effects of reduced European or U.S. exports to Greece—and thus reduced capital investment in these countries—would be similarly quite small. In 2014 the United States exported \$205.9 billion in goods to the Eurozone. This amount was about 12.8 percent of total U.S. goods exports—which, in turn, were about 9.3 percent of total U.S. 2014 GDP of \$17.4 trillion. Imagine that a default shrinks by 10 percent all spending by Greek households and businesses—and that, implausibly, all that spending reduction came in the form of fewer purchases from U.S. exporters. This drop in U.S. exports of about \$20 billion would constitute only about $\frac{1}{10}$ th of 1 percent of U.S. GDP. Yes, that would be a lot of money to the American businesses hit with canceled orders. But for the economy overall, this drop in exports would fall within the usual measurement error in the GDP measures produced by the U.S. Bureau of Economic Analysis.

The one possible economic impact of a Greek default that paradoxically might be most important yet is most difficult to quantify is there is the small but nonzero chance that default triggers another financial crisis of the magnitude of the World Financial Crisis of 2008–2009 triggered by the default of the U.S. investment bank, Lehman Brothers.

There are sound reasons not to expect such a crisis. Today the majority of Greek sovereign debt is owned not by banks and other private investors but rather by public entities: other sovereign Governments, the IMF, and the ECB. Eurozone banks today have stronger balance sheets than in years, thanks to changes including capital accumulation as part of regulatory stress tests. And, the ECB is currently implementing its own “quantitative easing” program of buying substantial amounts of member-country sovereign debt, one impact of which is to support confidence in financial markets and in the broader economy. All of this means that the losses of default would be borne by other Governments (and, implicitly, their taxpayers) rather than by banks—and, to the extent that banks would incur some losses, they are better positioned today to absorb those losses without destabilizing runs and/or sharp credit contractions.

All this said, no one really knows what will happen in global capital markets if Greece defaults and/or exits the Eurozone. All the world’s ex ante analysis, meticulous and thoughtful though it may be, simply has no historical precedent as a guide. Before Lehman died, as its stock price slid and as creditors and other counterparties jogged, wise voices intoned that a medium-sized U.S. investment bank could do only so much damage. Those wise expectations were proven very wrong as traders and counterparties reacted in diverse and unexpected ways, which in turn triggered asset-price movements and comovements that even today we do not fully understand. No one can plausibly rule out such destabilization in the wake of a Greek default. Imagine a massive post-default panic to sell the debt of Spain, Portugal, and Italy—and to then buy U.S. Treasuries—that leaves illiquid one of the world’s largest and most-heavily leveraged hedge funds. As all its counterparties lose confidence in it and in each other, a post-Lehman lending freeze could again materialize around the world in another financial crisis.

The Medium-Term Default Consequences: Greater Risks of Further Euro Exits

In the medium term, a Greek default would raise the risks of additional highly indebted and struggling countries exiting the Eurozone. A Greek default accompanied by an exit from the Eurozone would set a precedent that had been intended to be an impossibility: of a Eurozone member reverting to its own sovereign currency.

Currency unions such as the Eurozone function much like regimes in which member countries fix their currency values yet maintain separate currencies. For example, in either regime each member country cannot freely increase or decrease its money supply based on conditions in its own country alone. The main advantage of currency unions is—or so it is often hoped by their creators—irrevocability that eliminates the possibility of the speculative attacks that so often have bedeviled fixed exchange-rate regimes. Indeed, a major impetus for creating the Euro in the late 1990s was the early-1990s turmoil of waves of speculative attacks against the Exchange Rate Mechanism (in which many member countries effectively chose to fix the value of their currencies to the German Deutschmark). The British Pound, for example, was ejected from the ERM and floated in September of 1992 when specu-

lators such as George Soros forced the Bank of England to relent its fix after sustaining losses of tens of billions of Pounds.

A “Grexit” would shatter the intended permanence of the Euro and would revive the idea that Eurozone countries can create and print their own currencies. Quite simply, afterward no Government official could credibly claim that the Grexit was a one-off event never to be repeated. Investors and politicians alike would focus more on the actions of the Grexit, not on any words thereafter.

How likely is it that in the years ahead another Eurozone country would exit the Eurozone? That is impossible to predict, but surely post-Grexit this likelihood would be higher than before. And, the pressures for additional exits would arise from two forces—potentially interrelated. One is investors demanding higher interest rates from countries they perceive to be possible exitors. The other is fringe parties—already surging in countries such as Spain, with radical party Podemos—that might speak favorably about, and follow the policies of, Syriza in Greece.

One important indicator will be whether or not Eurozone countries manage to spur faster economic growth, as is discussed below. Countries lacking such policies—perhaps partly because of fringe parties coming to power—will be countries where interest rates rise, as they did in many weak Eurozone countries in 2010 and 2011. The combination of higher interest rates and all the related uncertainty would tend to depress hiring and economic growth, and thereby would trigger a dynamic not unlike that of Greece in recent years. The broader global economy would suffer from slowdowns (or outright recessions) in these countries, through the trade and investment linkages outlined above.

And any future exits from the Euro would surely bring greater chances of triggering the financial crises described above, because of how much larger and interconnected other countries are compared to Greece. Yes, a Grexit might not spark crisis. But what about an exit by Spain or by Italy?

The Long-Term Default Consequences: From Where Will Growth Come?³

In the long term, a Greek default is largely irrelevant to the fundamental challenge still facing Greece and every other advanced country: how to foster growth of jobs, incomes, and output in societies with aging populations and looming entitlement pressures. In this sense, the default question is not the most important question facing Greece today. Rather, that honor goes to a different question: Will the Syriza Government—or any Government after it—be able to foster growth in Greece’s labor force, capital investment, and productivity?

For any country on the planet, long-run economic growth requires an ability to accumulate some combination of labor, capital, and productivity. Yes, policy to support aggregate demand through efforts like ECB quantitative easing is important to employ currently idle people and capital. And, yes, the outcome of this week’s debt-renegotiation game of chicken will influence companies’ investments and innovativeness in Greece. But what will ultimately create sustainable economic recovery and hope in Greece is growth in its economic potential thanks to growth in some combination of these three factors. Without policies to spur their growth, no amount of debt renegotiation or forgiveness will matter.

It is useful to remember precisely how and why the Greek economy plummeted. There were years and years of economic mismanagement, which was never reflected in the country’s official statistics (statistics that were later revealed to be highly compromised). A handmaiden of the mismanagement was widespread corruption and highly restrictive regulation that protected well-connected groups and stifled entrepreneurship. Here is one example among many: in 2013, the Government acknowledged 343 professions had been effectively closed to outsiders.

Syriza tapped into a wellspring of resentment over the country’s economic woes; Prime Minister Alexis Tsipras has pledged to “bring an end to the vicious circle of austerity.” But the reforms announced thus far since his recent election are not obviously policies aimed at long-run growth: raising the minimum wage by 10 percent, reversing public-sector layoffs, and halting privatization. There has been discussion of raising taxes on hotels—one of the few sectors that remains healthy—and even restricting their ability to offer all-inclusive packages.

Regardless of how Greece and its creditors resolve their differences, the country will still face long-term growth challenges that must somehow be addressed. For example, its total population fell by about 200,000 people between 2001 and 2012 (and has surely declined even more since then)—a function of low birthrates, low immigration, and high out-migration. The median age is also projected to be 43.5 this

³Much of this sub-section is excerpted from “The Most Important Question Facing Greece”, The Slaughter & Rees Report, February 2, 2015, available at <http://cgbg.tuck.dartmouth.edu/news-events/blog/slaughter-rees-report-the-most-important-question-facing-greece>.

year (an increase of 10 years since 1970), which is one of highest in the world. Demographically, Greece has quickly become like already-shrinking Japan. And who is fleeing Greece are almost surely the more-talented, more-dynamic of its workers.

Greece is also saddled with low levels of innovation and very low spending on research and development. Increasing that spending—e.g., by continued deregulation of the economy to incentivize private R&D spending and investment—could deliver a number of benefits: spurring domestic innovation, keeping Greek companies in Greece, attracting immigrants and foreign direct investment, and perhaps even persuade some of the millions of Greeks living abroad to return to their ancestral home.

Greece has made some growth progress; for example, it has improved its position in the World Bank's Doing Business rankings from 109 in 2011 to 61 today. No other country has come close to achieving this improvement over the past 4 years. One encouraging sign: Uber, which is in the crosshairs of regulators throughout the world, has been operating freely in the country thus far in 2015.

But so much work remains if Greece is to raise its potential for long-term growth in output, jobs, and incomes. One place to start would be working through the 555 regulatory restrictions that the OECD, working in partnership with Greek authorities, identified as undermining competition and handicapping the Greek economy.

Greece's experience over the past few years is a potent reminder to countless other countries that anti-growth public policies today have consequences that can accumulate far into tomorrow. And those consequences are intensified when capital and labor can move around the world to where it is welcomed and rewarded. Lest we all wag our fingers at Greece as uniquely profligate, keep in mind that the dynamic of aging populations and looming entitlement pressures—all approaching when in recent years public debt has already spiked and economic growth has already slowed—faces many advanced countries today.

According to the IMF, gross public debt as a share of GDP has surged pretty much everywhere in the wake of the World Financial Crisis. From 2007 to 2014 it increased in the United States from 67.2 percent to 104.8 percent, in the Eurozone from 66.4 percent to 94.0 percent (e.g., in Italy from 103.1 percent to 132.1 percent), and in Japan from 183.0 percent to a staggering 246.4 percent.

What is Europe, for example, to do? Even ECB President Mario Draghi knows that ballooning the ECB balance sheet would accomplish only so much. Economic sluggishness across the continent reaches back decades. Consider this stunning statistic: total factor productivity (TFP)—which reflects the efficiency of capital and labor used together, and growth of which is central to long-run growth in output, jobs, and wages—is lower today in France, Italy, Spain, and Germany than it was in 1980. The U.S. TFP increase during this period has been about 35 percent.

Boosting TFP tends to require long-term, wise investments in areas including education, skilled immigration, and competition—both domestic and international—in product markets, labor markets, and capital markets. In a recent interview Mr. Draghi acknowledged that “progress on the important structural reforms—more flexible labor markets, less bureaucracy, lower taxes—is clearly too slow.” Asked to specify which Eurozone countries need to prioritize these reforms, he didn't mince words. “All of them.”

And what is the United States to do? U.S. productivity growth has slumped in recent years to many-decade lows. Output per worker hour in the U.S. non-farm business sector grew in the 4 years of 2011–2014 by just 0.2 percent, 1.0 percent, 0.9 percent, and 0.7 percent, respectively. Contrast this with the late 1990s and early 2000s: in the decade of 1995–2005, productivity growth averaged 3.0 percent per year. This surge was widely visible in accelerated growth in U.S. GDP, jobs, and worker earnings. At one point in 2000, U.S. unemployment dipped to just 3.9 percent and for several years during this period earnings rose briskly for all U.S. workers—even less-skilled workers including high-school dropouts. These large economic gains spread even to the U.S. Government, for which unexpected surges in tax receipts led to Federal-budget surpluses from 1998 through 2001, the first in generations.

America today continues to confront a competitiveness challenge of too little economic growth, of too few good jobs, and of real earnings for most of those working not rising. The good news is there is a future in which America can create millions of good jobs connected to the world via international trade and investment. Doing so will require bold and thoughtful U.S. policies, however, that extend beyond fiscal and monetary stimulus whose viability and impact are questionable. Productivity growth to spur growth in output, jobs, and incomes for American workers is within reach—but only if America finds a way to pursue wise policies such as business-tax reform that reduces rates and complexity, high-skilled immigration expansion, trade and investment liberalization, and sound investments in public infrastructure.

Conclusion

Greece has a glorious past. If it can use the ongoing crisis as an opportunity to transform its economy, and unlock economic opportunity, it could have a glorious future as well. Debt discussions of today must not obscure the deeper reforms that are needed for attaining that future. The current Greek crisis, however it is resolved, does nothing to address the fundamental long-term problem of how to accelerate economic growth. Indeed, by crowding out the attention of policy and business leaders, the current crisis aggravates this looming long-term problem.

The same is true for so many other advanced countries in the world, including the United States. Wise leaders will reflect on Greece, not as a unique outlier but rather as a sobering leading indicator for the challenges that are approaching.

Thank you again for your time and interest in my testimony. I look forward to answering any questions you may have.

PREPARED STATEMENT OF CARMEN M. REINHART

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JUNE 25, 2015

Thank you, Chairman Kirk and Ranking Member Heitkamp, along with the other Members of the Subcommittee, for the opportunity to comment on the unfolding crisis in Greece and its global ramifications. I am currently a professor at Harvard Kennedy School. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises and their economic consequences, including international contagion. One of the main lessons emerging from this work is that, across countries and over time, severe crises follow a similar pattern.

I will organize my remarks around three connected topics: (i) developments in Greece, as these relate to the Greek Government's potential default later this month or sometime this summer and the country's likely exit from the Eurozone in that event; (ii) the repercussions of such an exit on European economies, particularly periphery countries (Ireland, Italy, Portugal, and Spain); (iii) the possible broader repercussions of the crisis on the United States, global currency markets, and emerging market economies.

The Situation in Greece

I will focus on the multiple possibilities of default. Even if events are arranged so that the Greek Government meets its obligations to the International Monetary Fund at the end of this month, the probability of a default over the course of the summer looms large. There are many reasons why default appears probable. Consider the top two.

First, the widespread loss of confidence in the sustainability of the status quo has led to a sharp escalation in internal arrears (public and private). The private sector, concerned about the likelihood of an exit from the euro and a renewed contraction in economic activity, has increasingly defaulted on existing debts; about half of the bank loans are nonperforming and the share rises to more than $\frac{3}{4}$ if credit card debt is included. Tax payments are postponed or avoided, aggravating an already precarious fiscal position. The attempt to hoard euros by the citizenry is also manifest in the sharp escalation of deposit withdrawals. A very conservative estimate would indicate that deposits have fallen by around 45 percent since their peak in 2009. The combination of a rapidly shrinking deposit base and a staggering share of nonperforming loans imply that the banking sector is near a bank holiday. The Government is financing itself by not paying its bills, similar, for instance, to what transpired ahead of the Russian default of August 1998 or Argentina at the end of 2001. Also, general Government deposits in the banking sector were off more than 40 percent at the end of April.

Second, the approximate 1.6 billion euro payment due to the IMF at the end of this month is only a fraction of the amounts coming due in July, August, and September, which total about 7, 5.6, and 6 billion euro, respectively. These payments are a multiple of current Government cash balances. At present, Greece is allocating less than 2 percent of GDP to interest payments, so even another round of compromise from official creditors that would delay such payments would not free up significant resources, so as to deal with domestic arrears and external payments on maturing debts.

European Contagion

A point of departure in assessing the current scope for contagion from a Greek default is the absence of the “surprise” element.¹ In my work on contagion, I have found that “fast and furious” financial contagion is far more likely when the triggering crisis takes investors and Governments by surprise.

There is no surprise here. Because the Greek drama has been unfolding over several years, private sector exposure to Greece (that is to say, outside of Greece) has declined sharply since the spring of 2010. Prior to the financial crisis, most Greek debt was in the hands of private external creditors (banks and nonbanks, as shown in Figure 1). Such financial links increased the odds of significant spillovers. During the past 5 years, official creditors (including the IMF and the European Central Bank) have absorbed Greek sovereign debts. Thus, at this time the scope for contagion via financial channels is limited. Real-side exposure to Greece via trade is not a new factor to consider, as Greek GDP has approximately contracted by 25 percent since the outset of the crisis, which an even bigger contraction in imports from the rest of Europe. Whether investors become indiscriminate and pull out of other European periphery countries in the event of a Greek default still remains a risk. The likelihood of such a scenario, however, is mitigated by the fact that a significant share of sovereign periphery debt (particularly Portugal and Ireland) is also in official hands, that these countries have been recovering much more rapidly than Greece, and that in such an event periphery Europe would receive support from the center and from the IMF.

Implications for the United States, Global Currency Markets, and Emerging Market Economies

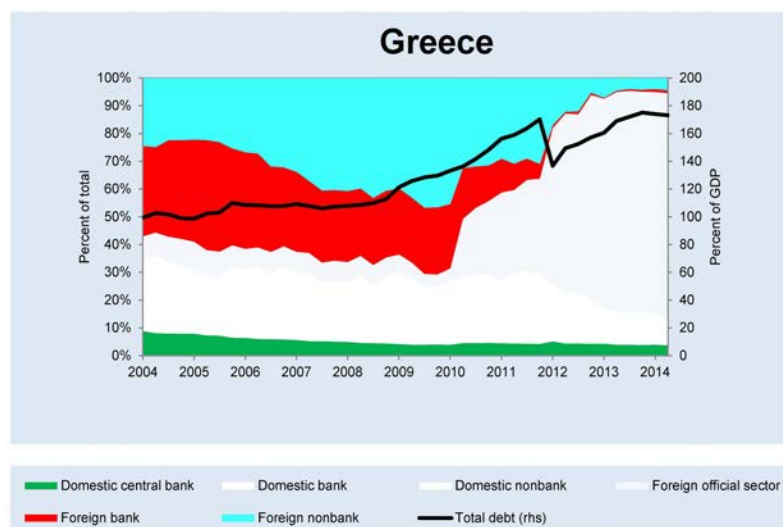
The effects of a Greek default, probably in the context on an exit from the eurozone, on the United States are likely to be very limited in scope. Financial exposure, which was comparatively marginal in the first place, is not a prevalent source of concern for U.S. financial institutions. Nor is the Greek market a major destination for U.S. exports. Predicting currency fluctuations is an elusive goal for economists, so take my observations with a healthy dose of skepticism. If a Greek default triggers substantial turmoil in Europe, we would see a flight to safety into U.S. dollar assets, notably Treasuries. This has been the “standard” pattern of response in past waves of global volatility. If so, further appreciation in the U.S. dollar vis-à-vis the euro and most other currencies follows. In this setting, the potential adverse effects of an appreciating dollar would be largely felt by U.S. manufacturing, not unlike the impacts already seen earlier this year.

In terms of broader consequences, an appreciating dollar may act as a headwind in the Federal Reserve’s efforts to begin the process of pulling its policy interest rate off the zero lower bound. Also, many emerging markets with dollar-denominated external debt (whether these are public or private) would be other things equal, worse off with further dollar appreciation.

Greece is already close to financial autarky. It relies almost entirely on support provided by the ECB and other official lenders. The gap between a de jure default and a de facto one has narrowed significantly. As a result, the next stage in this crisis may have limited consequences for the global economy.

¹See Kaminsky, Graciela L., Carmen M. Reinhart, and Carlos A. Vegh, “The Unholy Trinity of Financial Contagion”, *Journal of Economic Perspectives*, Vol. 17(4), Fall 2003, 51–74.

Figure 1. Who Holds Government Debt, 2004-2014



Source: Arslanalp Serkan and T. Tsuda (2014). "Tracking Global Demand for Advanced Economy Sovereign Debt" *IMF Economic Review*, 62(3), 430-464.

PREPARED STATEMENT OF JACOB FUNK KIRKEGAARD
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JUNE 25, 2015

Subcommittee Chairman Kirk, Ranking Member Heitkamp, Members of the Subcommittee on National Security and International Trade and Finance, it is a pleasure to testify before you today on the global impact of a—hypothetical—Greek default.¹ In my written testimony, I will address two issues; the probability of a Greek default and its implications on the eurozone and the global economy, and the exposure to the U.S. taxpayer from loans given to Greece by the IMF.

The Probability and Implications of a Greek Government Default on Greece, the Euro Area, and the Global Economy

In light of ongoing negotiations in the euro area, it is at the time of writing an open question if the Greek Government can avoid a default against its official sector creditors, as well as whether the IMF gets paid on time on June 30th and arrears to the organization thus averted.

Substantial amounts of political brinkmanship are being utilized to achieve a negotiated outcome, which aims to see a self-identified radical leftist anti-austerity Government agree to a reform package with the Troika in exchange for the continuation of financial support.² Whatever today's negotiation situation is, it remains a near certainty that an agreement will eventually be found in the coming weeks. The principal question is whether an agreement will require a brief period of restrictions on the Greek banking sector to be sealed or not.

This ultimate ability to find an agreement with the current or a new Greek Government is of the utmost importance, as it suggests that Greek Government debt

¹I am grateful to my colleagues at the Peterson Institute for ongoing and highly rewarding discussions of this and related issues, in particular Edwin Truman, Avinash Persaud, Joe Gagnon, Douglas Rediker, Angel Ubide, William Cline, Nicolas Veron, and Adam Posen. Any remaining errors conveyed are solely mine.

²Sometimes officially now referred to as the "Brussels Institutions", consisting of the IMF, the European Commission and the ECB, with the EuroGroup functioning as the European entity politically agreeing to the technical proposals of the Troika.

is and will most likely in the future remain sustainable, despite the country's extremely high gross Government debt levels of 177 percent of GDP in 2014³ and uncertain future growth prospects.

This conclusion follows from the particular current structure of Greek Government debt, which is overwhelmingly held by the other euro area members, the IMF as a super-senior creditor, and with remaining privately held debt at very long maturities and low nominal interest rates (See Figures 1 and 2). Consequently, the cost of servicing and therefore the financial sustainability of Greek Government debt is largely unrelated to the size of gross debt or financial market fluctuations. The country currently faces very small debt payment obligations until at least 2023, and already has a substantially longer debt maturity profile and substantially lower implied rate of interest on its debt than for instance the United States Federal Government (Figure 3).

Rather Greek debt sustainability and ability to avoid a future default is dependent on two things; the Greek Government's ability to restore economic growth in the country, or in other words the continuation of growth-friendly structural economic reforms, and the country's ability to reach an ongoing political agreement with its official sector creditors in the euro area and the IMF. Unlike the IMF, the euro area has—as has already been done in June 2011, March 2012 and November 2012⁴—the political freedom to restructure its Greek Government debt holdings in a manner closely calibrated to the preceding degree of Greek Government delivery of agreed structural reforms and fiscal targets. Provided the Greek Government in the future offers politically satisfactory implementation of an agreed program, the euro area will, in accordance with earlier promises to consider “further measures and assistance, including inter alia lower cofinancing in structural funds and/or further interest rate reduction of the Greek Loan Facility, if necessary, for achieving a further credible and sustainable reduction of Greek debt-to-GDP ratio”,⁵ offer the country further debt restructuring. Such additional restructuring of the euro area holdings of Greek Government debt will, however, only be contemplated once the Greek Government has proven its commitment to faithfully implementing a program agreed with the Troika. Ex ante debt relief to Greece will not be granted.

Recalling that Greece is a small country, accounting for only 1.8 percent of total euro area GDP, and hence does not pose a material risk to overall euro area financial stability (see also Table 1), Athens' ability to avoid a future default is a question of the Government's domestic reform capability and internal euro area politics, not objective debt sustainability criteria or financial markets.

In short, Greece is and will remain solvent if the euro area wants it to be.

Discussions about the implications of a Greek Government default are per the above likely to remain hypothetical. If the Greek Government were nonetheless to default, the precise circumstances and against which creditors it did so would determine the consequences. Failure to for instance pay the IMF on time on June 30th, 2015, would not immediately and independently have any real consequences for Greece, as it per IMF (2012:21) would merely initially result in: “Staff sends a cable urging the member to make the payment promptly; this communication is followed up through the office of the concerned Executive Director. The member is not permitted any use of the Fund's resources nor is any request for the use of Fund resources placed before the Executive Board until the arrears are cleared.”⁶

Only following a lengthy internal procedure lasting up to 24 months could Greece face expulsion from the IMF.

However, were Greece to go into arrears against the IMF on June 30th, 2015, as a result of a failure to reach an agreement with the Troika, the European Central Bank (ECB) would in all probability almost immediately stop, or at least substantially scale back the ongoing provision of emergency liquidity assistance (ELA) to the Greek banking system.⁷ This would make it impossible for the Greek banks to operate and necessitate the imposition of a bank holiday, or at least severe deposit access controls at the institution level, which again would throw the Greek economy into another dramatic economic decline.

³ Eurostat data at <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1>.

⁴ See ESM (2015:29) for the details of these earlier restructurings of euro area holdings of Greek debt. Available at http://www.esm.europa.eu/pdf/204204_ESM_RA_2014_web.pdf.

⁵ Eurogroup Statement on Greece, November 27th 2012, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/133857.pdf.

⁶ Available at <http://www.imf.org/external/np/pp/eng/2012/082012.pdf>.

⁷ Latest available data for May 2015 indicates ELA had reached approximately \$87bn (up 4bn from April). See <http://www.reuters.com/article/2015/06/24/eurozone-greece-ecb-idUSA8N0Z300J20150624>.

The political effects of deposit access controls—which importantly under new Banking Union regulations could potentially be imposed by the central euro area banking supervisors at the ECB against the will of the Greek Government—on the Greek economy and financial system would likely be dramatic, and in all probability sooner or later lead to sufficient domestic political pressure for the Government to reach an agreement with the Troika. This would restore ECB support for the Greek banking system and broader Troika financial support. As such, any actual default by the Greek Government against any official sector creditor is likely to be of relatively short duration.

Notions that it, given its current projected small primary fiscal surplus, would be in Greece's economic interest to declare a sudden unilateral and total default against its public and private creditors are based on a dangerously simplistic understanding of the close financial, political, economic and budgetary ties between Greece and especially its euro area and EU partners.

Such a unilateral default against its creditors would for instance result in the immediate loss of ECB support for the banking system and thus cause the instant closure of Greek banks system and a highly probable loss of ongoing EU budget support of around 3 percent of GDP.⁸ Any current projected Government primary surpluses in Greece would quickly as a result of slumping growth, disappearing net budget transfers and declining Government revenues be converted into likely sizable Greek Government primary deficits. Any defaulting Greek Government would ultimately not be able to pay even the claims of its domestic Greek stakeholders, undermining its political support. Moreover, it should be emphasized that the lessons from economic history concerning the aftermath previous sovereign defaults are of relative limited predictive value for the likely effects in a country like Greece, which is a relatively closed economy with limited export potential, has a far older population, a much larger Government share of GDP than earlier recorded sovereign default cases.

A Greek sovereign default would have very, very severe domestic economic consequences for Greece, yet a Greek default does not imply an automatic, or even probable, departure of Greece from the euro area (the so-called Grexit). Default against some or all its official sector creditors could be implemented by any incumbent Greek Government simply by failing to pay its dues on time, in the same manner the current (and previous) Greek Government has gradually run into sizable arrears against many of its domestic Government suppliers.⁹ Leaving the euro, however, would represent a reversal of nearly 40 years of Greek economic and political participation in European integration. It would in all probability require an explicit public mandate to the Government to undertake such a momentous volte face. Given how a large majority of at least two-thirds of the Greek public and over 80 percent of Greek MPs (including both parties in the current governing coalition) has consistently supported staying in the euro,¹⁰ such a public mandate look politically impossible in Greece for the foreseeable future.

Occasionally researchers seek insights into what a Grexit might involve from previous recent dissolutions of currency unions in for instance the Soviet Union, Yugoslavia, or Czechoslovakia. Such historical comparative work though is of limited relevance, as Grexit would not involve the dissolution of the euro, but rather attempts by a Greek Government to (re)introduce its own national currency, while the euro would continue to function more or less as before.

Concerns expressed by some that the departure of one member of the euro would invariably result in the collapse of the common currency are excessively alarmist for at least two reasons. First, it is highly unlikely that populations in other euro area members would attempt to emulate what would for certain be a highly disruptive and economically destructive Greek departure from the euro. And secondly, it does in light of the institutional deepening witnessed in the euro area since 2010 seem probable—if politically very challenging—that the remaining euro area members would following a Grexit implement additional integrative measures among themselves, including additional political and fiscal integration, in order to counter renewed centrifugal political and economic forces inside the common currency area.

The fact that any Greek Government would seek to (re)introduce its own currency, while the euro would still be in normal circulation has important implications for the likelihood of success of such a new currency. Recalling how a large majority of the Greek population wishes their country remains in the euro, and that any new

⁸See European Commission data at http://ec.europa.eu/budget/mycountry/EL/index_en.cfm.

⁹See latest Greek Government budget implementation data at <http://www.mnec.gr/?q=en/content/state-budget-execution-january-may-2015>.

¹⁰See discussion here <http://blogs.piie.com/realtime/?p=4756>.

Greek currency would be backed solely by the credibility of Greek governing institutions, it seems highly unlikely that a new Greek currency would be imbued with the key currency function as a “store of value”.¹¹ When presented with a choice between a new national currency and the still circulating euro, Greek residents are—when not potentially legally prevented from doing so¹²—overwhelmingly likely to demand euros. This suggests any new Greek currency will quickly decline in value relative to the euro and the country suffer a rapid nominal currency depreciation.

Being a relatively small economy, which imports many essentials (energy, food, medicine, etc.) and exports only a relatively limited number of often volatile items (tourism and shipping services), Greece has a more limited scope for import substitution and dramatic changes in exports than larger and more diversified economies. The pass-through from a declining nominal exchange rate to domestic inflation in Greece following the introduction of a new currency is thus likely to be strong. This again means that achieving a lasting reduction in the Greek real exchange rate from introducing a new currency will be difficult and only potentially achievable in conjunction with a material—and highly regressive—increase in the domestic inflation level. All told, attempt by the Greek Government to implement Grexit by introducing a new currency is likely to fail to improve the economic outlook for the Greek population and fail to displace the euro as the dominant currency in circulation in the Greek economy.

Consequently, the actual effect for a defaulting Greece of losing access to banking sector support from the ECB, financial aid from the Troika and budgetary transfers from the EU budget, is not a smooth transition to a new national currency. Rather, it is a disastrous high domestic inflation scenario. Unable to successfully switch to a new national currency, the country ends up a bit like Montenegro, which unilaterally euro-ized its economy in 2002. Attempts at Grexit will de facto mean that Greece has only left the institutions of the euro area/EU, not the currency itself.

Highlighting the dramatic difficulties of actually (re)introducing a national currency by a Government with low institutional credibility, when the previous anchor currency remains in circulation, is also witnessed in the ongoing usage of the U.S. dollar. No modern economy that has ever fully adopted the U.S. dollar (e.g., full currency substitution as for instance seen in Ecuador, Panama and El Salvador)—has ever undone the decision and re-introduced their own national currency. There is little reason to believe that Greece now in the euro would manage to do so either.

A Greek default would prove devastating to the Greek economy even without a Grexit, and the costs passed on to the euro area would be sizable, but not economically or financially catastrophic. Private sector exposures to Greece through trade (Figure 4) and the banking sector (Figure 5) are today limited and manageable. Public sector exposures in the euro area from financial assistance (excluding IMF loans) and liquidity assistance provided to Greece amount to about 3.3 percent of euro area GDP, ranging from 1.4 percent in Ireland to 5 percent in Malta (Table 1 provides total “worst-case” exposures assuming a recovery rate of zero). These exposures are large and would in already fiscally challenged countries, such as Italy, Portugal, or Spain, prove a material additional burden on Government finances. They will not, however, in all probability cause any other euro area sovereign to risk losing market access.

The most pressing economic policy problem arising from a Greek default for the euro area would be for the ECB, as it would dramatically complicate plans ongoing asset purchases, currently scheduled to end in September 2016. It would first and foremost be up to the ECB to ensure that any potential financial market cross-border contagion effects—likely only at a magnitude far below what was seen in 2012 in the euro area—would not pose a threat to euro area growth. The ECB is likely if required to act decisively and be successful in this task.

Most likely, the ECB would in a Greek default scenario feel compelled to expand current levels of asset purchases (€60bn/month), as well as potentially postpone any exit. Given the relatively limited level of financial asset purchased to date by the ECB in comparison with other major central banks like the Federal Reserve, such additional monetary stimulus would not pose any noteworthy financial risk or economic problems.

¹¹ The store of value function of a currency is one of three key attributes. The other two are the functions of medium of exchange and unit of account. To successfully function as a store of value, a currency has to be capable of being predictably saved, stored, and retrieved for (roughly) the same value. In other words, any currency inflation affecting it must be kept within a certain range.

¹² The Greek Government might for instance pay wages or accept payments from residents only in a new currency, or require that bank deposits covered by any deposit guarantee scheme in Greece be held in their new currency.

Recalling the limited present day private sector exposures to Greece, direct risks to global growth beyond the euro area from a default are relatively limited and linked to threats to the euro area regional growth outlook. However, given likely ECB policy activism, the generally robust euro area economic performance to date (short-term Q2 indicators point to around 1.6 percent growth annualized with June composite PMIs at 49-month high¹³), the lower levels of external and budget deficits now found in the euro area, and new euro area institutions put in place since 2010, the regional fallout from a Greek default is likely to be contained and not derail the current euro area cyclical recovery.

In sum, a default by the Greek Government will quickly prove an economic disaster for Greece, though for that reason domestic political pressures to seal a deal with the Troika will keep any failure to pay international creditors brief. Any default by Greece will not automatically lead to Grexit, and it will under any scenario likely prove impossible for a Greek Government to successfully reintroduce a national currency. Improving euro area economic performance, a more resilient—though still incomplete—institutional structure in the euro area, and not least additional ECB monetary stimulus is likely to contain any cross-border spillovers from a Greek default. As a result, a Greek default does not pose systemic risks to either the euro area or the global economy.

The Exposure of the U.S. Taxpayer to Loans Provided to Greece by the IMF

As noted in the previous section, any actual default by the Greek Government is likely to be relatively short-lived. The domestic economic implications would be very negative through the rapid introduction of a bank holiday/bank deposit controls, while the domestic political reactions hereto would in all probability produce the required domestic political pressure on the Greek Government to seal a deal with the Troika. As a result, any financial risks for the IMF appear quite limited, as Greece would eventually secure the required funding from the euro area or from own funds to repay the IMF.

It appears a relatively high risk, but not the base case, that Greece may not pay the IMF the approximately \$1.7bn due on June 30th, precipitating the serious domestic economic and political implications discussed above. However, from the perspective of the IMF, new Greek arrears of this magnitude would not pose any financially material risk and would only approximately double the IMF's current levels of arrears of \$1.8bn.¹⁴ This would take total member State arrears to the IMF back to levels of the early 1990s,¹⁵ but not in any way affect the operations of the IMF or pose any threat to its shareholders, including the United States.

Total current IMF exposures to Greece from the 2010 Stand-By Arrangement and 2012 Extended Fund Facility amount to approximately \$39bn,¹⁶ currently scheduled to be fully repaid only by 2026 (Figure 2). The IMF is Greece's super-senior creditor, and any potential future euro area additional debt restructuring of its Greek debt holdings are likely to include a conversion of costlier IMF loans into longer maturity and cheaper ESM loans, implying that the IMF's exposure to Greece is likely to be eliminated before 2026. Both issues suggest that the actual financial risk to the IMF and its shareholders from lending to Greece is relatively limited, as the IMF will ultimately get fully paid back, even as euro area taxpayers will surely not in net-present-value terms.

Consequently, estimates of potential liabilities to the U.S. taxpayer from IMF lending to Greece should be treated as a very low-probability worst-case scenario.

The United States' IMF quota stands at 16.74 percent, implying that the United States' share of total current Greek IMF exposure of about \$39bn is approximately \$6.5bn.

In relation to the U.S. Government and economy, this is a very small number, amounting to 0.2 percent of 2014 Federal Government outlays and 0.04 percent of U.S. 2014 GDP.

¹³ <http://www.markiteconomics.com/Survey/PressRelease.mvc/986c020abdb0457f9574c56ff8a80e79>

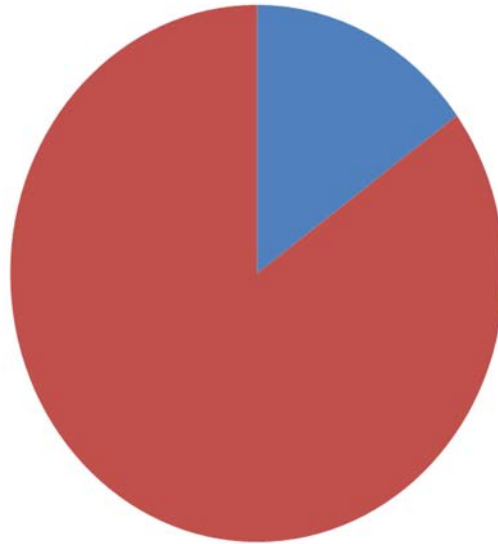
¹⁴ Owed to the IMF by Somalia, Sudan, and Zimbabwe. Data from May 31st 2015 at <https://www.imf.org/external/np/fin/tad/extdbt2.aspx?valueDate=2015-05-31>.

¹⁵ Table 5 in IMF (2012) available at <http://www.imf.org/external/np/pp/eng/2012/082012.pdf>.

¹⁶ See overview of Greece's financial position in the IMF at <http://www.imf.org/external/np/fin/tad/exfin2.aspx?memberKey1=360&date1key=2015-06-25>.

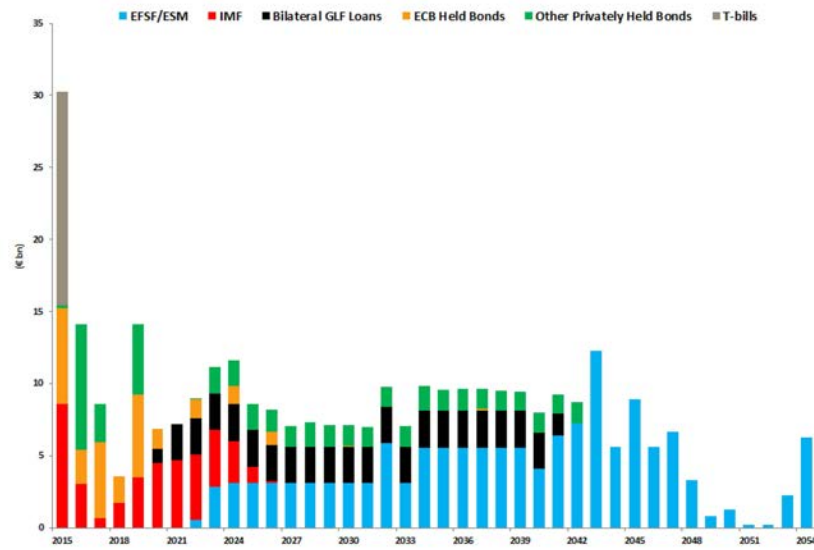
Figure 1 Greek Government Debt Ownership By Sector, Spring 2015

■ Private Sector - 15% ■ Public Sector - 85%



Source: ESM

Figure 2 Greek Debt by Type and Maturity, €bn



Source: RBC Capital Markets

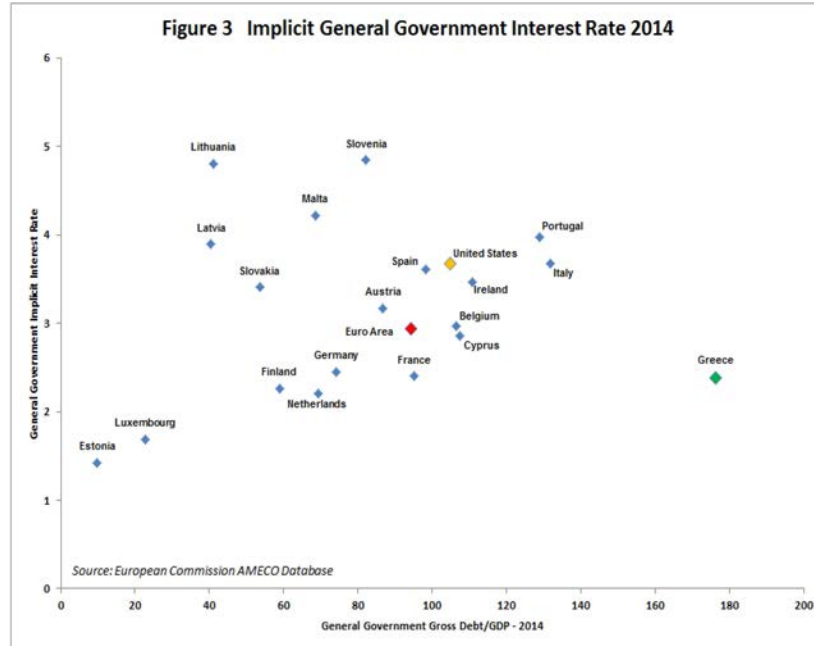
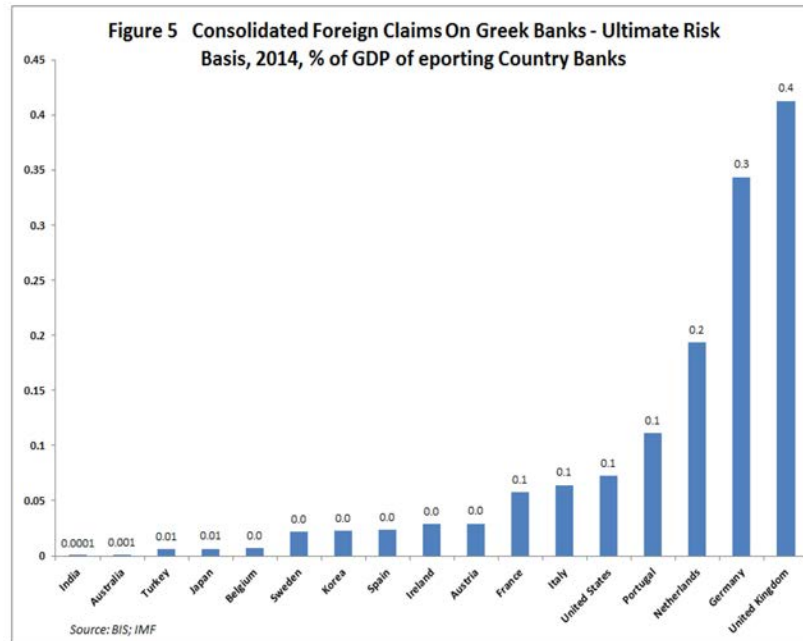
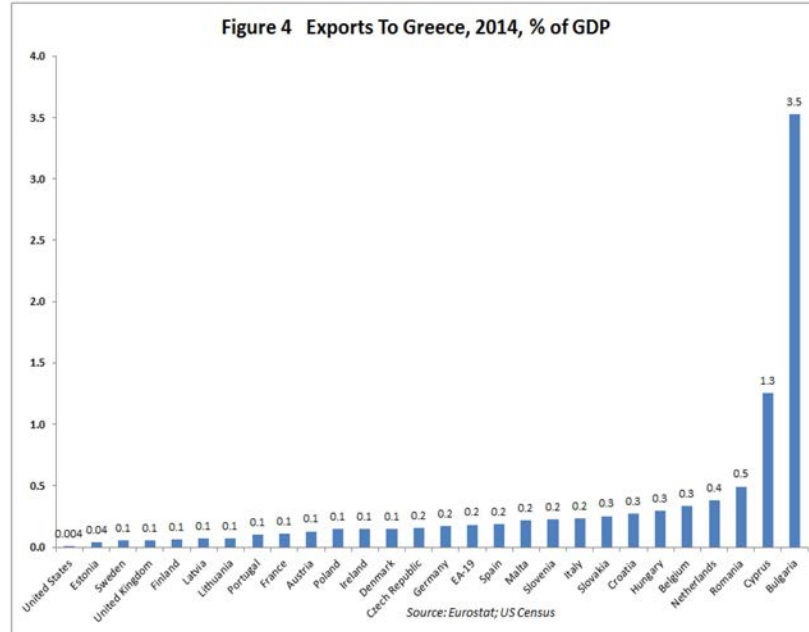


Table 1 Euro Area Financial Exposures to Greece April/May 2015

	Member States		Eurosysteem/ECB		Total	
	Bilateral Loans €bn	EFSF/ESM €bn	SMP €bn	Intra-Eurosysteem (Target2) €bn	€bn	% of GDP
Austria	1.6	4.3	0.9	3.4	10.2	3
Belgium	1.9	5.2	1.1	4.1	12.3	3
Cyprus	0.1	0	0.1	0.2	0.4	2.4
Estonia	0	0	0.1	0.3	0.4	4
Finland	1	2.7	0.6	2.4	6.7	3
France	11.4	30.9	5.6	22.8	70.7	3.3
Germany	15.2	41.2	7.2	28.9	92.5	3.2
Ireland	0.3	0	0.6	2	2.9	1.4
Italy	10	27.2	4.9	19.9	62	3.8
Malta	0.1	0.2	0	0.1	0.4	5
Netherlands	3.2	8.7	1.7	6.7	20.3	3
Portugal	1.1	0	0.7	3	4.8	2.6
Slovakia	0	1.6	0.4	1.1	3.1	4.2
Slovenia	0.2	0.6	0.2	0.7	1.7	3.9
Spain	6.7	18.1	3.6	14.4	42.8	4
EA Total*	52.9	140.7	27.7	110	331.3	3.3

* Luxembourg, Latvia and Lithuania excluded from table due to small size (Lux) and late euro entry. Slovakia did not by political choice provide bilateral loans to Greece. Eurosysteem exposures distributed according to ECB ownership key, excluding Greece

Source: Author; ESCB; Eurostat



**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE
FROM DESMOND LACHMAN**

Q.1. I'd like to hear more about the policy choices Greece made that led to their debt crisis, prior to Greece's 2009 announcement that it had been understating its deficits.

My understanding is that Greece's public employment grew five-fold from 1970 through 2009, at a growth rate of 4 percent. Over the same time period, private sector employment increased by only 27 percent, at an annual growth rate of less than 1 percent. How much did Greece's expanding public sector contribute to their debt crisis?

A.1. Greece's expanding public sector was one of the principal factors in Greece's public deficit ballooning between 2000 and 2010. It has also been one of the major factors that has sapped vitality from the Greek economy. As such it has to be regarded as a primary contributor to the country's sovereign debt crisis.

Q.2. Beyond debt payments and public sector employment, are there other particular sectors—for example such as defense spending—during the lead up to their debt crisis where Greece's Government spending levels were imprudent?

A.2. Aside from public wages, the uncontrolled increase in pension payments has been a major factor in the deterioration of Greece's public finances. Currently pension payments in Greece account for over 17 percent of Greek GDP and they are very much more generous than in other European countries.

Q.3. What is Greece's labor participation rate, how does it compare to other Eurozone countries, and did it contribute to Greece's fiscal crisis? Are these statistics similar to those found in other Eurozone countries?

A.3. According to the World Bank, Greek labor participation is only 53 percent. While low, it might be noted that other European countries like Italy also have very low participation rates. Meanwhile the participation rate in Germany is only 60 percent.

Q.4. Beyond a generally underperforming economy, what else explains Greece's low labor force participation rate? For example, does their welfare and entitlement system encourage such a low participation rate?

A.4. Besides generous welfare and entitlement programs, a major contributor to low participation is Greece's very rigid labor market and onerous labor market regulations which make it difficult to hire and fire workers. In that respect, Greece is not alone in Europe in needing major labor market reform.

Q.5. How much of the blame for Greece's debt crisis can be blamed on tax evasion?

A.5. Tax evasion in Greece is rampant and is certainly a contributory factor in the debt crisis. Besides from directly impacting the public finances, it means that tax rates are very high and onerous on that small part of the population that does pay taxes. This is hardly conducive to economic growth.

Q.6. How much of the blame for the crisis can be placed on Greece's membership in the Eurozone, either because of the con-

straints Eurozone membership places on Greece, or because of efforts Greece underwent to secure Eurozone membership?

A.6. Euro membership is at the core of the Greek crisis for many reasons. From the very outset, placing a highly sclerotic country like Greece in a currency arrangement with an economic powerhouse like Germany was to invite problems in the competitiveness field. In addition, Euro membership had the effect of lowering interest rates at which the Greek Government could borrow to German levels. Those low borrowing rates facilitated Greece's public sector going on a spending spree. When the music stopped, Greece found that attempting to redress domestic and external balances in a Euro straitjacket contributed importantly to sinking the economy into a 1930s style economic depression. That in turn contributed to Greece's rising public debt to GDP ratio.

Q.7. What other significant factors, demographic or otherwise, contributed to Greece's debt crisis?

A.7. Greece certainly engaged in reckless borrowing that got the country into its debt crisis. However, it is a truism that one cannot have reckless borrowing without there also being reckless lending. In the Greek case, Greece could never have got into its monumental debt problem to the degree that it did without the willing help of the German and French banks, which lent recklessly to the Greek Government.

Q.8. How far back in time would Greece have to go to prevent this debt crisis, and what policy changes would be necessary then to place Greece on a stable footing now?

A.8. It is difficult to overstate how many major policy changes would be required to put the Greek economy on a stable footing. The economy would need to be modernized through fundamental reform to the labor market, the pension system, to tax administration, and to the privatization of State assets. Greece would also need to be accorded major debt relief by its official creditors. The country would also need to engineer an orderly exit from the Euro that would provide the conditions for a recovery in the economy.

Q.9. This hearing touched on the impact of austerity on Greece's dire economic situation. For example, Mr. Lachman argued that "at the heart of Greece's economic collapse has been the application of draconian budget austerity within a Euro straitjacket," which "preclude exchange rate depreciation or the use of an independent monetary policy." While I understand this argument, Greece's irresponsible fiscal policy is what led to their debt crisis in the first place. It seems reasonable to expect Greece to make structural changes to their economy before they can receive help from other creditors.

How significant of an economic drag has "austerity" been on Greece? Why?

A.9. While Greece might have lagged in the area of structural reform policy, the size of its fiscal adjustment over the past 5 years has been enormous. Despite an economic depression, Greece has reduced its budget deficit from around 15 percent of GDP in 2010 to around 3 percent of GDP at present. There can be no doubt that this constituted an enormous amount of fiscal drag.

Q.10. Has austerity been particularly hard on Greece, as compared to other countries? Why?

A.10. Other European countries like Ireland, Portugal, and Spain did massive budget adjustment as well but not on the scale of that of Greece. In addition, an economy like that of Ireland displayed much greater labor market flexibility than did Greece and, having a large export sector, Ireland was able to offset at least in part some of the negative effect of budget tightening on aggregate demand.

Q.11. Couldn't you argue that some form of austerity was inevitable, because of the deep fiscal hole that Greece had dug itself in? Shouldn't any country with a structural fiscal deficit exceeding 18 percent of its GDP—as Greece had in 2009—go through austerity measures?

A.11. There is no question that Greece needed major fiscal adjustment. However, it was unreasonable to expect that this degree of fiscal adjustment could be effected in a Euro straitjacket without sending the economy into the deepest of economic recessions. As the IMF itself now recognizes, Greece's situation would have been more manageable had the country restructured its privately owned sovereign debt very much earlier than it did. The country's situation would also have been made more manageable had it exited the Euro as soon as the very large size of its domestic and external imbalances became apparent.

Q.12. Will austerity lead to longer-term economic growth, even if it may be difficult in the immediate-term?

A.12. The latest round of austerity imposed on Greece by its European partners within a Euro straitjacket is misguided and is bound to end up in tears. It basically repeats the policy approach of the past that contributed to Greece's economic depression. There is no reason to think that such policies will work this time around.

Q.13. Are there other structural economic reforms in the public and private sector that Greece could enact alongside austerity, to create the best conditions for growth?

A.13. Greece has to modernize its economy if it is to have sustainable economic growth. In addition to basic reform of pensions, the labor market, and tax administration, Greece needs to move away from its patronage system and to improve its basic governance.

Q.14. This hearing contained a lot of discussion about the sustainability of Greece's debt levels. On the one hand, Greece has more than a 175 percent debt to GDP ratio and has a significant amount of debt due over the next 3 months. On the other hand, others argue that Greece has a relatively low interest rate burden, a favorable debt repayment timetable, and low borrowing rates from the bailout fund. Is Greece close to insolvency? Or is it only illiquid, but solvent?

A.14. A fundamental mistake made by the IMF at the start of the Greek sovereign debt crisis in 2010 was to treat Greece's problems as one of liquidity and not of solvency. Greece's situation is very much worse today than it was in 2010 and the country is patently not able to repay its debt. That is not to say that Greece nec-

essarily needs to have its debt written down through reducing its face value. However, it is to say that Greece needs to have its debt maturities extended and its interest rates reduced in a major way.

Q.15. I'd like to focus on Russia's influence in this debt crisis. Russia has said that it is considering giving Greece a bailout. Russia has also announced that Greece has agreed to let the Russian State-owned energy giant, Gazprom, build the Turkish Stream natural gas pipeline in Greece.

How significant of a possibility is it that Russia will step in at some point in the near future to resolve Greece's debt problems?

A.15. Russia should not be expected to step in and resolve Greece's debt problems. However, should the Greek crisis deepen and should anti-European sentiment in Greece grow, one must expect Russia to take advantage of the political opportunity of gaining a firm foothold in the country.

Q.16. What is Russia's strategic interest in developing stronger ties to Greece?

A.16. In 1947, the Truman doctrine recognized Greece's geopolitical importance as a gateway to the Middle East as well as to the Mediterranean. Today Greece retains that strategic importance. The warm welcome Vladimir Putin has accorded to Alexis Tsipras in Moscow should be a reminder that Russia has real interests in the Balkans.

Q.17. What would Greece have to give Russia in exchange for accepting Russia's support?

A.17. The immediate prize that Mr. Putin is seeking is to build a pipeline that would carry Russian gas to Europe through Greece and Turkey. One would also think that Russia would have an interest in Greece's ports.

Q.18. Could Russia afford to bail Greece out, economically?

A.18. Russia is known to play a long game. While low international oil prices are placing a strain on the Russian economy at present, this is not expected to last forever. In addition, the amounts of money that it would cost Russia to gain real influence in Greece are not inordinately large.

Q.19. Would Putin have to worry about internal political dynamics that could constrain him from bailing out Greece?

A.19. Judging from Mr. Putin's behavior in Ukraine, it would seem that Mr. Putin is very much in control of Russia's external policies.

Q.20. Would Russia's increased influence in Greece prove to be a destabilizing factor in the region or in the broader Eurozone?

A.20. At a time that Russia is proving itself to be a major menace in Ukraine, the last thing that Europe and the United States need is having Russia gain an opening in Greece.

Q.21. How significant of a hindrance has Eurozone membership been for Greece? Does this call into question the viability of the Eurozone model for smaller countries?

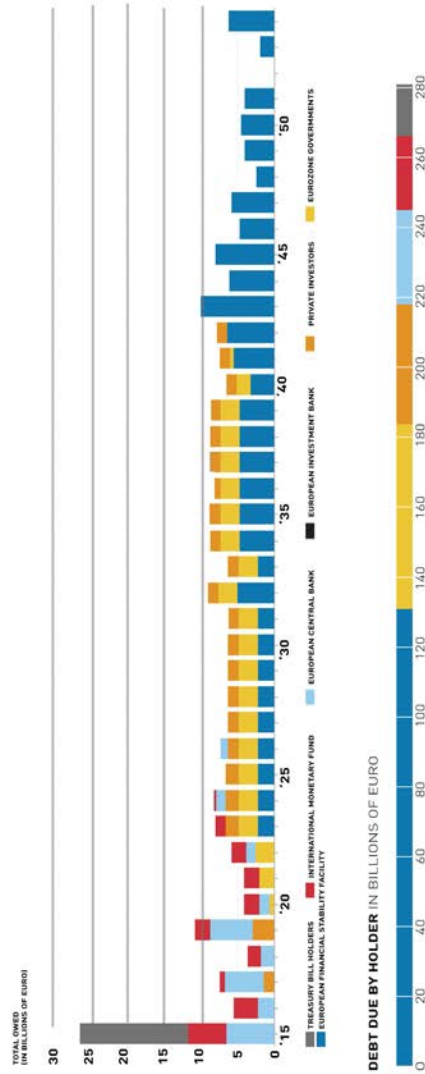
A.21. For reasons explained above, Eurozone membership has been a major mistake for Greece. There are many lessons for the other highly indebted European countries like Italy, Portugal, and Spain.

Among the most important of these lessons is that those countries have to effect major structural reform and soon in order to get their economies moving if they are successfully to resolve their debt problems in a Euro straitjacket.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

WALL STREET JOURNAL CHART OF GREEK DEBT DUE 2015-2055

GREEK DEBT DUE 2015-2055



OFFICE OF SEN. MARK KIRK
SOURCE: WSJ

CRS/NATIXIS CHART OF TOTAL GREEK DEBT OWED

